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IDB STRATEGY WITH COSTA RICA

IDB GROUP

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CONTENTS

EXECUTIVE SUMMARY
THE BANK'S COUNTRY STRATEGY MATRIX

I. POLITICAL, SOCIAL, AND ECONOMIC BACKDROP 1

A. The political sphere 1
B. Social conditions 1
C. Recent economic performance 3
D. The macroeconomic outlook 5

II. KEY DEVELOPMENT CHALLENGES 8

A. Development challenges: The competitiveness imperative 8
1. Consolidate the Macroeconomic Environment 8
2. Accelerate production growth to seize global integration opportunities 10
B. The government's strategy 16

III. ANALYSIS OF THE BANK'S PREVIOUS STRATEGY AND PORTFOLIO ANALYSIS 17

A. The 2000-2002 strategy 17
B. Portfolio performance 18
C. Evaluation of the Bank's country program 21

IV. THE BANK'S OBJECTIVES AND STRATEGY AND THE AGENDA FOR DIALOGUE 22

A. Objectives 22
B. Strategy focuses 23
1. Strategy focus I: Consolidation of macroeconomic stability 23
2. Strategy focus II: Acceleration of production growth to seize global integration opportunities 25
C. The lending program 27
1. The program 27
2. Lending scenarios 30
D. Coordination with other development cooperation providers 31
E. Debt with the Bank and sustainability of the country's external debt with the proposed strategy 32
F. Monitoring and evaluation of the strategy 32
G. Risks of the proposed strategy 34

V. AGENDA FOR THE COUNTRY DIALOGUE 36

ANNEXES

Annex I	Summary of the Bank's operations program
Annex II	Program of research and analytical papers
Annex III	Selected references

ABBREVIATIONS

BCCR	Central Bank of Costa Rica
BSCR	The Bank's strategy with Costa Rica
CA	Central America
CABEI	Central American Bank for Economic Integration
EU	European Union
FTAA	Free Trade Agreement of the Americas
FTA-CA	Central America-U.S. Free Trade Agreement
FTA-EU	Free Trade Agreement with the European Union
ICT	information and communications technologies
IDB	Inter-American Development Bank
IIC	Inter-American Investment Corporation
IMF	International Monetary Fund
MIF	Multilateral Investment Fund
NDP	National Development Plan
NLPs	nonlending products
PBL	policy-based loan
PPP	Puebla-Panama Plan
PRI	Private Sector Department
SIEPAC	Central American Interconnected Power System
SINE	National Evaluation System
SMEs	small and medium-sized enterprises
SUGEF	Superintendency of Financial Institutions
TCs	technical cooperation operations
WEF	World Economic Forum

FOREWORD

This strategy is the fruit of coordinated efforts of different Bank Group arms and departments (RE2, SDS, INT, RES, PRI, MIF, IIC) which pooled their inputs and shared their expertise on Costa Rica in a document that was used as a basis for an initial policy dialogue meeting with the new government held on 7 June 2002. Follow-up actions included sector-specific discussions and further inputs from the operational divisions to enrich the dialogue with Costa Rican authorities.

In July 2002 the government unveiled its 2002-2006 Economic Revitalization Plan. At a fresh round of meetings organized around that date the country's needs were discussed with the Bank's Governor for Costa Rica and representatives of the Economic Council, the Legislative Assembly, and civil society. In late October 2002 the thrust of the new strategy was discussed during a consultation mission with the government. One focus of the dialogue was the diagnostic assessment, to make sure the authorities concurred. Activities that would be priority focuses of the Bank's support, in light of its comparative advantages, were described. The National Development Plan released by the government in November 2002 matched the priorities that had been discussed earlier.

In January 2003, the Governor of the Bank for Costa Rica and the President of the Central Bank met with Bank staff in Washington to review the programming.

In consultation meetings held in May 2003 to review the strategy paper with civil society and government representatives the concurrence of all parties in the diagnostic assessment was confirmed, as was the common thrust of actions proposed to remedy the problems.

As the strategy was being developed, close contact was maintained as well with the leading international cooperation providers in Costa Rica to ascertain their programming plans and draw on lessons learned from their experience. Other inputs into the strategy were findings and recommendations of the 1991-2001 country program evaluation conducted by the Office of Evaluation and Oversight (OVE).

The programming associated with the strategy reflects areas of consensus as to the new administration's reform priorities. The authorities have forwarded concrete fiscal proposals to the legislature. Also included in the programming are investment projects needed as adjuncts to the reforms to achieve the objectives being pursued.

EXECUTIVE SUMMARY

Background

As a new administration took office in May 2002 Costa Rica marked over 100 years of democracy. Two decades of robust economic growth have dramatically improved Costa Rican living standards, as evidenced by social indicators that exceed Latin American averages.

The human capital development levels achieved in Costa Rica and the nation's sturdy institutions and legal framework have helped create an environment of social peace, legal certainty, and citizen security and a political setting conducive to consensus-based decision-making. Keynotes of this harmonious climate have been gradual public policy adjustments and an economy in which the public sector continues to figure prominently, notably in the infrastructure, utilities and basic services, and financial sectors. This climate having proved highly attractive to foreign investors in the technology and manufacturing sectors, the country's growth pattern has been driven by external demand, with few connections to the rest of the economy.

Global economic adversity in the past two years affected Costa Rica's economic performance, as declining terms of trade, the slowing world economy, and the country's reliance on external saving laid bare the economy's vulnerability.

Development challenges

Costa Rica's preeminent challenge is to achieve the objective of its National Development Plan, which is to reduce poverty. In the dialogue with the Bank the authorities emphasized that they intend to attain this objective by **accelerating economic growth**, to be propelled by competitiveness improvements in the production sectors in a setting of social cohesion and harmonious coexistence at home and mounting competition in the global economy that makes efficiency improvements imperative.

The country's development agenda speaks directly to the challenge of making its goods and services production more competitive. This entails cross-cutting, cross-sectoral actions in segments of the economy that have a part to play in developing Costa Rica's production apparatus.

The actions that will be required of government and private enterprise on these fronts can be grouped under two overarching challenges: (i) **consolidate the macroeconomic environment** and (ii) **make goods and services production more competitive**, to make the most of the global integration opportunities afforded by trade agreements and treaties and the Central American integration process.

These two challenges are very closely intertwined, macroeconomic stability being a prerequisite for Costa Rica to become more competitive.

A key requirement for **consolidating the macroeconomic environment** will be to reduce the country's recurring fiscal deficits. In the 1990s the public deficit averaged 3.4% of GDP; in the last three years it has widened, reaching the equivalent of 5.9% of GDP in 2002, according to IMF figures. The pressures that the state of the public finances has put on the economy have shown up in an inflation rate that has held at around 10%, high real interest rates, a balance of payments current account deficit, and a sizable public debt stock. There has been little scope for private sector growth in such circumstances.

Many factors come into play for the **development of Costa Rican production and the competitiveness of the country's goods and services**. Among the most salient are: (i) the institutional and social environment; (ii) the cost of doing business in the country; (iii) production-related factors; and (iv) sustainable development of the rural economy.

The Bank's strategy for 2003-2006

The starting points for the Bank's new strategy with Costa Rica are the set of lessons learned in pursuing the previous strategy, the government's priorities, and the international environment that is being reshaped as integration processes deepen. The strategy also takes account of the Bank Group's comparative advantages to help the country tackle the challenges that await it over the next four years.

The objective of the Bank's strategy with Costa Rica (abbreviated herein as BSCR) for 2003-2006 is to support the government's efforts to achieve more rapid, sustained economic growth driven by competitiveness improvements in the production sectors and making the most of the opportunities afforded by integration. This will enable the country to continue making inroads against poverty.

In order to address the challenges facing the country and the government's priorities, the strategy will focus on two areas: (i) consolidation of macroeconomic stability, and (ii) acceleration of production growth to seize global integration opportunities. The gains sought on these two fronts will be mutually reinforcing and growth enabling: macroeconomic stability is a prerequisite for growth, and swifter development of the nation's production apparatus will help solidify its external position and boost domestic saving, cushioning the impact of the adjustment.

Strategy focus I: Consolidation of macroeconomic stability. The BSCR will support government moves to implement sweeping fiscal reforms to help achieve fiscal sustainability by modernizing tax policy and tax administration and public sector financial management at both the central and subnational government level. The strategy also envisages support for efficiency improvements in government financial management, underpinned by a budget process that would promote performance-based resource allocation and consolidation of the performance-based evaluation system.

The stable macroeconomic framework will create the conditions necessary to attract more private investment, and this will boost productivity.

Strategy focus II: **Acceleration of production growth to seize global integration opportunities**. If Costa Rica's growth pattern is to be sustainable, its goods and services sectors need to develop quickly so they can become more competitive. As a parallel process, linkages need to be forged between export businesses and the rest of the economy so that the country can make the most of the opportunities being afforded by integration to become a fuller partner in the global economy.

Competitiveness improvements targeted for support in the BSCR center on two key concerns: (i) creating a pro-growth environment and (ii) developing productive investment.

a. **Creating a pro-growth environment**. The BSCR will assist in the strengthening of institutions that will be working to further trade liberalization, the modernization of government financial management, and strengthening of the institutional apparatus for the infrastructure, financial, and basic services sectors. The strategy also will continue to support initiatives to enhance legal certainty regarding investment and property rights, improve access to justice, and cut red tape for investors.

b. **Development of productive investment**. The objective of Bank Group activities[1] throughout the strategy period is to help lower the logistical and financial costs of doing business in Costa Rica. To that end the BSCR will support: (i) infrastructure development in the transportation sector and for Central American electrical integration; (ii) efficiency improvements in financial intermediation and greater availability of credit to small and mid-sized businesses; (iii) productivity improvements, through knowledge generation and technology adoption in production processes; (iv) sustainable development of the rural economy, and (v) human resources training to better equip Costa Ricans for the job market.

The lending program

To implement the BSCR a US$695 million lending program[2] is being proposed for 2003-2006. The centerpiece of the program, to directly pursue the twin strategy focuses outlined above, is the two-stage program of support for competitiveness improvements.

The strategy also envisages four programs (see Annex I) that will indirectly support the two strategy focuses. One will help alleviate urban poverty and support human capital development, the aim being to improve the urban economic growth environment and, concurrently, enhance prospects for mainstreaming marginalized populations. Another proposes to modernize the Legislative Assembly to strengthen institutional capacity for its operations and thereby foster more efficient legislative decision-making.

Two binational programs along Costa Rica's borders with Panama and with Nicaragua will advance Central American integration and heighten competitiveness, to further sustainable integrated development of these border regions. This will help deepen integration and, in the process, improve the quality of life of communities in these two areas.

The BSCR places great emphasis on products, which will be designed so as to ensure their effectiveness and synchronize programming with political cycles as much as possible. This will be accomplished thanks to the faster startup of new programs supported by the strategy once arrangements and formalities for their launch are expedited. Likewise, the programming leaves room for potential new Bank programmatic lending products (see the Bank Country Strategy Matrix below).

Risks

Risks for the Bank's strategy have to do with the country's macroeconomic stability, specifically the state of the public finances, the public debt burden, and the difficult international climate. Though the strategy will help bolster the public finances and make Costa Rican goods and services more competitive, thereby giving the country a greater foothold in the global marketplace, political consensuses will be necessary to move the planned reforms along. Otherwise, important changes could end up being deferred, limiting the country's room for maneuver and accentuating its vulnerability. The BSCR will help further the government's consensus-building efforts, providing support for an informed dialogue underpinned by sound analysis and referencing successful experiences.

One potentially serious constraint for attaining the program's objectives, which thus could lessen its impact, is the implementing capacity of State institutions. The government has pledged to speed up the legislative process for loan approvals, whereupon the programs envisaged in the Bank's strategy could begin sooner. This would expedite implementation of new programs that align with the government's priorities.

Indicators

The BSCR matrix presents two sets of indicators. The first set, listed in the second column from the right, are indicators proposed by the government. Though primary responsibility for achieving the respective targets lies with the government, the Bank's program outlined in this strategy paper will assist the government in attaining them. Heading this first set of indicators are a reduction in the poverty rate from 20.5% in 2002 to 16% in 2005, an increase in GDP growth from 2.8% in 2002 to 4.5% in 2006, a reduction in the fiscal deficit, and an increase in nontraditional exports (without INTEL). These indicators serve as guidelines for the BSCR.

The second set of indicators in the matrix (right-hand column) reflect outcomes sought with the Bank's program. Though the commitment is primarily on the government's part, here the Bank and the country will share responsibility for attaining the targets.

Some of the targets set out in the BSCR are ambitious ones, and will only be achieved through a concerted effort by the government backed by strong international community support. Outside factors that could impede their attainment include natural disasters and political, economic or financial unforeseeables. Consequently, an evaluation of the Bank's role in achieving the indicators will have to take into account the responsibility-sharing and counterfactual considerations that have come in for lengthy discussion in the Bank's Board of Executive Directors.

THE BANK'S COUNTRY STRATEGY MATRIX

The government's medium-range objectives: Lower the poverty rate from 20.5% in 2002 to 16% in 2006 and increase GDP growth by 0.4% annually, on average[3] (base year 2002, 2.8% GDP growth). These government targets will be the frame of reference for the country strategy targets.

Development objectives	Government strategy	Other donors' activities	IDB strategy	IDB funding		Performance indicators	
				Execution	Programmed	Government	IDB
Strategy focus I: Consolidation of macroeconomic stability. (Indicator: reduction in overall consolidated public sector fiscal deficit by 1% of GDP annually, on average, over the period 2003-2006. Baseline: 5.9% of GDP in 2002.)							
Achieve fiscal sustainability	Reduce the fiscal deficit: increase revenues and rationalize spending.	**United States**: Institutional reform. **France**: Customs modernization; advisory support for statistics and censuses. **Spain**: Institutional modernization and strengthening.	Tax policy and tax administration reforms and strengthening (central and municipal governments). Institute measures to rationalize public spending.	TC loan: Structural reform (1997)	**Loans**: Program to support competitiveness improvements; PBL to support reforms for competitiveness (first stage); PBL to support consolidation of the public finances (second stage). **TCs**: Rationalization of public spending and national budgeting; municipal strengthening; municipal program for financial sustainability and competitiveness; strengthening of taxation and customs sectors. **NLPs**: Financial sector monitoring system (regional).	- Increase in the primary surplus to 2%-3% of GDP in 2005. Baseline: -0.3% of GDP in 2002. - Fiscal Adjustment Act or equivalent in force in 2004. - Creation of National Taxation Directorate, 2005.	- Increase in tax revenues from 13.3% of GDP in 2002 to 16% of GDP in 2006. - Lowering of public spending by at least 1.5% of GDP in 2006. Baseline: 23% of GDP, 2002. - Municipal revenue modernization plan designed (taxes, rates, betterment levies) by 2006.
Increase efficiency of public spending, with an emphasis on social expenditure	Increase efficiency of public services to expand coverage and improve quality.		Improvements in public expenditure allocation, management and targeting , with an emphasis on social spending. Improvement of the budget system. Strengthening of National Evaluation System (SINE) to measure government agency efficiency.		**Loan**: PBL to support reforms for competitiveness (first stage) and PBL to support consolidation of public finances (second stage). Investment Facility for Growth and Competitiveness: Modernization of the State, including strengthening of local governments . **TCs**: Study on social spending. SINE strengthening **NLPs**: Tax policy for human development; impact and performance measurement in social project management.	- Increase in social-sector efficiency, measured by per-recipient cost of services (2005). Baseline will be established - Performance-based allocation of public investment funding in 2006, based on performance contracts. - Budget programming, control and evaluation system implemented in 2005. - By 2006, a 20% reduction in time required to formalize foreign investment contracts. Baseline: four months in 2002.	- Options identified for improving civil servants' productivity [per-employee allocation for social programs] in Health and Education ministries (2004). - In 2005, move from traditional line item budgeting to performance budgeting (i.e., budgeting as a planning tool). - Budget programming, control and evaluation system designed in 2004. - Consolidation of the beneficiary targeting system in all State institutions (2006).

[3] Like the other macroeconomic goals, this is an indicative target. It assumes also that the other factors remain constant.

Development objectives	Government strategy	Other donors' activities	IDB strategy	IDB funding		Performance indicators	
Strategy focus II: Acceleration of production growth to seize global integration opportunities. (Indicator: increase in nontraditional exports without INTEL by an average of 5% per year. Average baseline 2001-2002: US$3.49 billion.)							
Create a pro-growth environment (to develop the private sector and boost investment)	Improve competitiveness: enhance government efficiency, promote decentralization and citizen participation, improve the financial and banking system, and expand e-government services. Enhance citizen security, strengthen the rule of law and improve the urban environment. Modernize the workings of the legislature.	**European Union, Netherlands and Germany**: Decentralization and municipal government. **Spain, U.S.A., France, Netherlands and China (Taiwan):** Institutional modernization and strengthening.	Modernize institutions involved in trade liberalization, starting with customs service. Support trade liberalization, improve efficiency and strengthen public sector institutions for infrastructure and financial services delivery. Preserve social peace and the rule of law and improve the urban environment.	**Loans**. Modernization of the administration of justice, first and second stages. Regularization of cadastre and registry office. **MIF**: Biodiversity development; strengthening of capital markets and public works concessioning; consolidated financial system supervision; air transportation security.	**First stage**: **Loan**: Investment Facility for Growth and Competitiveness. - Digital management strategy for the fiscal area, including Customs. - Customs modernization to adapt the customs service to trade liberalization. **Loan** for urban poverty alleviation and human capital development. **Loan** to modernize the Legislative Assembly, to increase its efficiency and expedite decision-making.	- Computerized tax administration system, including customs services, set up and operating in 2006. - Improve ranking on World Economic Forum (WEF) **Public Institutions Index** (baseline: 2002 rank of 46). - Improve citizen security, lowering the violent-crime rate from 189 per 100,000 population in 2000 to 140 in 2005. - Public input into lawmaking, by creating legislative links with communities and equipping the legislature with new technology, in 2006.	- 10% increase in customs collection by 2006. Baseline 2002: US$1.003 billion. - In 2005, processing time for import/export reduced to one working day. - In 2005, computerized system in use in five judicial districts to speed up proceedings and dispute resolution. - Technology infrastructure of the Legislative Assembly designed and in operation to reduce government employees' administrative workload and facilitate analysis and decision-making (2005).
					Second stage: **Loan**: Investment Facility for Growth and Competitiveness: - Modernization of the State in areas that affect competitiveness. - Support for finance reform. - Government procurement and contracting. **TCs**: National environmental management program; strengthening of public and municipal utilities regulator. Management training.	- Improve ranking in **Quality of the National Business Environment** subindex (MICI) (baseline: 2002 rank of 47). - Reduce intermediation spreads to approximate those of El Salvador or Panama by 2006. - New government procurement and contracting processes implemented and operating, 2006. - Ministry of Environment and Energy restructured and equipped to manage FTA and PPP challenges in 2006.	- Improve Costa Rica's ranking for number of days required to start up a business (baseline: 2002 rank of 55 at 120 days - WEF). - In 2005, authorize SUGEF to perform consolidated supervision and make its recommendations binding. - Government procurement and contracting process reengineered in 2005. - Environmental management strategy agreed upon; water resources management fully defined, and critical activities implemented in 2006.

Development objectives	Government strategy	Other donors' activities	IDB strategy	IDB funding		Performance indicators	
					MIF: Institutional support for National Concessions Council (CNC); airport security; cleaner production in business sector. **NLPs**: Regional analysis of Central America-U.S. Free Trade Agreement (FTA-CA); evaluation of potential impacts of FTA-CA.	- Five regulations implementing the Environment Act developed in 2006. - CNC with at least three concessions awarded for highways, ports and/or airports in 2005.	- Three separate production chains (clusters) established and operating, taking in a total of 30 SMEs in 2006.
Support for development of productive investment	Modernization of production infra-structure to increase competitiveness and thereby further trade liberalization. Endow the population with knowledge and skills to enhance employment and income prospects. Give domestic companies access to credit.	**Germany, Canada, Spain, U.S.A., Taiwan**: Local roads, infrastructure, energy, transportation and telecommunications, tourism. **European Union**: Science and technology for development. **Germany, Japan, Spain, Canada, Denmark, EU, Finland, Sweden, Netherlands, Taiwan, Norway**: Poverty reduction, sustainable development. **Spain, U.S.A., France, Taiwan, Netherlands, Japan**: Education, health and early childhood; graduate fellowships; technical-vocational training.	Improve arterial and local roads, with an emphasis on PPP integration. Encourage private sector participation through concessions for road, port and airport construction. Support electric energy integration under the PPP. Lower businesses' financial costs such as intermediation, credit access for SMEs, and others. Foster adoption of innovation and new technologies in production processes, with an emphasis on SMEs. Expand coverage of	**Loans**: SIEPAC; electric power development III, ICE; sustainable agricultural development. Preschool and lower-secondary (third-cycle) education; primary health care services in low-income areas. **Small Projects**: Social entrepreneurship - León Cortés; development of medicinal plants . **TCs**: Support for SIEPAC project. Regional agriculture (FONTAGRO). Internet applications for education; FTA capacity building for women entrepreneurs; sustainable integrated development of Sixaola watershed; Heredia sewer system. **MIF**: Agricultural technology; biodiversity; software industry; support for Asociación Desarrollo Rural Integrado; development of local suppliers of multinational	**First stage**: **Loan:** Investment Facility for Growth and Competitiveness: - Rural road rehabilitation to improve competitiveness. - Incorporation of science and technology into production processes. - Secondary education and its employment relevance. - Support for foreign trade, including support for microenterprise and SMEs for the integration process. **- Loan** (regional): Sustainable development of Sixaola River binational basin (PN-CR).	- Average speed on rehabilitated rural roads increases from 15 to 40 km/hour. - Improve ranking on WEF **Technology Transfer Index**. Baseline: 2002 rank of 7. - Improve ranking on WEF **Innovation Index**. Baseline: 2002 rank of 36. - Increase net secondary school enrollment from 2001 level of 54.3% to 62.5% in 2006. - Average annual increase in gross fixed investment equivalent to 0.8% of GDP between 2004 and 2006 (baseline: 1999-2002 average, 18.2% of GDP). - Action plan in progress for border region development and regional goods management to pave the way for the countries' integration (PPP) (2006).	- Transportation costs on rehabilitated rural roads 15% lower in 2006. Baseline 2002, MOP. - Relative private-sector share of R&D spending climbs from 18% in 2002 to 24% in 2006. - Lower third-cycle day-session dropout rate from 2001 level of 12.9% to 10% in 2006. - Sustainable management plans are being implemented for protected areas that are highly vulnerable to natural hazards, in the Binational Park (2005).

Development objectives	Government strategy	Other donors' activities	IDB strategy	IDB funding		Performance indicators	
		World Bank: Water supply and sewerage. Ecomarkets program; interest in multigrade rural secondary education; health, population and nutrition program. **CABEI**: Roads; wind and hydro-electric power; global credit lines, SMEs and rural development.	secondary education and make it more employment-relevant to improve competi-tiveness in the medium and long terms. Foster integrated rural development, by incorporating tourism sector services.	high-tech companies; one-stop shop for SME formalization; agricultural credit initiatives. Technical-vocational training for women (MIF-regional).	**Second stage** **Loan**:Investment Facility for Growth and Competitiveness: - Sustainable development of the Huetar-Vertiente Atlántica region. **Loan**: Regional program for development of San Juan River binational basin (CR-NI).	- Decentralized capacity to manage the Huetar-Vertiente Atlántica region's development, raise communities' income and heighten private sector involvement (2006). - Progress toward border-region integration and investment targeting to zones with high poverty levels (2006).	- 20% increase in income and 60% improvement in quality of life, measured by indicators from the Huetar-Vertiente Atlántica project (2006). - Offer sustainable alternatives for production of traditional products in forestry, agriculture, fisheries and tourism (2006).
					PRI: San José-Caldera highway. Line of credit for SMEs. **TCs**: Development of Huetar-Limón region; environmental strategy; national water resources strategy; science and technology; secondary education; comprehensive barrio improvement; ICT training for women entrepreneurs. **MIF**: San José-Cartago highway concession; support for National Concessions Council in highways sector. Small Projects: expansion of microcredit for communities in southern Costa Rica; production and marketing of organic export crops in the south.. **NLPs**: Analysis of clean development in CA; watershed management study; CA rural finance strategy; FTA impact assessment; private sector involvement in post-secondary education; employment and training system.	- Implementation of Law on Strengthening of Microenterprise and Small and Medium-sized Businesses (2005).	

I. POLITICAL, SOCIAL, AND ECONOMIC BACKDROP

A. The political sphere

1.1 The new administration in office since May 2002 is headed by president Abel Pacheco de la Espriella, who led the ruling party to victory in the first-ever runoff election in over 100 years of democracy in Costa Rica. The division of the 57 legislature seats among the two traditional parties—PUSC (19) and PLN (17), a new party—Partido de Acción Ciudadana (PAC) (14 seats), Partido Movimiento Libertario (6 seats) and Partido de Renovación Costarricense (1 seat) could complicate legislative decision-making, which requires a qualified majority of representatives. The support of the new PAC party thus will be needed to pass legislation. Compounding the situation is the recent splintering of the PAC that gave birth to the Bloque Parlamentario Patriótico.

1.2 At the heart of Costa Rica's entrenched democratic tradition is its history of consultation and consensus-building as an integral part of the nation's pursuit of its citizens' welfare. This shows up clearly in governance indicators developed in various quarters, which place Costa Rica at or near the top of the region—in first place for voice and accountability, a measure of the extent of citizen participation in government; in second position, after Chile, for absence of corruption; in third place, following Chile and The Bahamas, for effective government,[4] and tied for first place with Chile and Uruguay for public trust in State institutions.[5] Even so, the voter abstention rate rose significantly in the last two presidential elections (18.9% in 1994, 30% in 1998 and 31.2% in 2002).

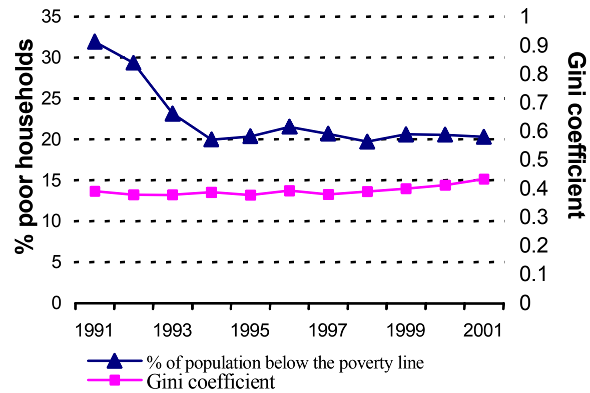
1.3 Since 1990 there have been sweeping reforms in municipal government, notably tax reforms at that level and moves to strengthen local autonomy by creating the post of municipal mayor. However, voter turnout for the country's first-ever direct mayoral elections in late 2002 was even lower (over 60% abstention) than the percentage who came out for the presidential elections. Though these municipal reforms will further the decentralization process, the apparatus of government in Costa Rica is still heavily centralized.

B. Social conditions[6]

1.4 Thanks to appreciable gains posted in the 1990s in reducing poverty and improving social indicators, Costa Rica is firmly on track to attain the Millennium Development Goals. More robust growth and increases in social spending over those years brought the poverty level down from 32% in 1991 to 20% in 2001. Extreme poverty declined from 12% to 6% over the same interval.[7] These gains in Costa Rica's social indicators are on a par with those posted by middle-income countries. Life expectancy at birth is 78 years; the child mortality rate is 13 per 1,000 live births; 98% of Costa Ricans have piped water service; only 4% of the over-15 population is illiterate; and the country has near-universal basic education and primary health care coverage.[8]

1.5 Despite the cumulative improvements over the course of that decade, in 1994 the rate of poverty reduction (using the income measure of poverty) began to level off, even though the economy continued to grow. This could be indicative of two things: the scant connection between free zone and high-tech export businesses and the rest of the economy and the limited access of the poor to good jobs and higher incomes because of their low skills levels. Another telling trend in recent years is income concentration as depicted by the Gini coefficient,[9] which moved from 0.374 in 1990 to 0.433 in 2001.

Figure 1.1 : Poverty reduction rates have leveled off and inequality has worsened



1.6 Another indicator of inequality is the disparity in availability of services. In the education system, for instance, only 15% of the poorest quartile obtain a high school diploma, compared to 59% of the wealthiest quartile. Even with the country's universal health care system, close to 30% of the poor have difficulty accessing the services offered by the Costa Rican Social Security Administration for the poor and the uninsured.

1.7 The status of women has improved considerably in recent years, the country having already met the Millennium Development Goals in this regard. Costa Rica is the only nation in Latin America and the Caribbean to achieve gender income equality. Women's education attainment is higher than men's and women have greater access now to land ownership.[10] Their political participation has increased as well—there are more women lawmakers in Costa Rica's parliament than in any other country in Latin America. Nevertheless, some gender inequities persist: women heads of household account for a high share (48%) of the population living in extreme poverty, and women's unemployment rate is higher than men's (7.6% compared to 5.2%).

1.8 Throughout the 1990s an influx of immigrants, whose poverty and birth rates are higher than Costa Rica's, put pressure on the social sectors, especially the public health care and education systems.[11]

1.9 Along with the slowing of poverty reduction rates in recent years there are signs that the pace of social sector gains is stalling as well, particularly in the areas of education and health coverage for the country's neediest. This is despite the rise in social spending, which climbed from 13% of GDP in 1990 to 19% in 2001 and is accounting for a growing share of the country's mounting public expenditures. This situation points up the need to retarget spending and make it more efficient, including outlays for social assistance programs targeted to the country's poorest.

1.10 There are marked differences in the social conditions of ethnic minorities: the percentage of Afro-Costa Ricans who are high school graduates and have done university studies exceeds the national average, whereas social indicators for indigenous groups (for academic attainment and access to essential services) are far below the national averages.

Immigration to Costa Rica and its impact

Close to 90% of immigrants arriving in Costa Rica come from Nicaragua. An estimated 250,000 Nicaraguans (6.6% of the Costa Rican population) are permanent residents of Costa Rica and somewhere between 60,000 and 100,000 (1.7% and 2.6%, respectively, of the population) take up temporary residence there, most of them undocumented. Three quarters of this migrant community is between 13 and 49 years of age.

Since this Nicaraguan labor force supplements the local workforce it is viewed as a demographic dividend for Costa Rica. The unemployment rate among Nicaraguan workers stood at 8.8% in 2002.

In 2000, medical treatment of foreign patients accounted for close to 5% of total health insurance system spending in Costa Rica. Most immigrants go to health facilities only in emergencies; this is one reason for the reemergence of diseases once eradicated and the rise in other diseases associated with poverty. In 2001 nearly 1.5% of the education budget was spent on education of Nicaraguan immigrants. Schools in areas with a high concentration of immigrants tend to be overcrowded; many of their students are over-age for grade and have lower skills levels. Nevertheless, these are not the worst-performing schools. Immigration also has pushed up the housing deficit.

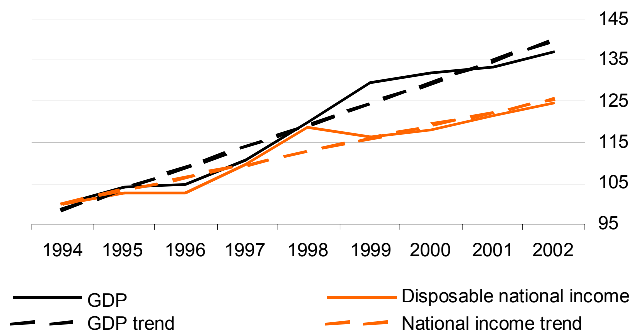
The majority of Nicaraguan immigrants live in low-income districts of cities. About 25.8% of them are poor and 8.9% are living in extreme poverty (higher than the national figures). However, a recent study drawing on household survey findings suggests that the stalling of poverty reduction rates can be attributed only in small measure to immigration.[12]

C. Recent economic performance[13]

1.11 The Costa Rican economy grew quickly throughout most of the 1990s, outperforming its Central American neighbors with an average growth rate topping 5.3%. The country's 10% inflation rate also was among the highest in Central America. Driving this robust growth were heavy investment (including INTEL investments), the impact of structural reforms—particularly trade liberalization and the opening of the banking sector to private participation, and pension system reform, all of which helped boost total factor productivity over that decade.[14] Also contributing was the pro-growth environment, characterized by a stable political system and a relatively skilled workforce.

1.12 The growing influx of foreign investment in high-tech and manufacturing businesses under the free-zone regime has triggered a new pattern of growth in Costa Rica, but this growth has had only a modest impact on national income because of the scant connection between those sectors and the rest of the economy and because tax exemptions available to businesses locating in the free zone have eroded the tax base. An analysis of real gross disposable national income[15] including the effect of the terms of trade puts average 1990s growth at 3.9%, well below the GDP growth figure mentioned above.

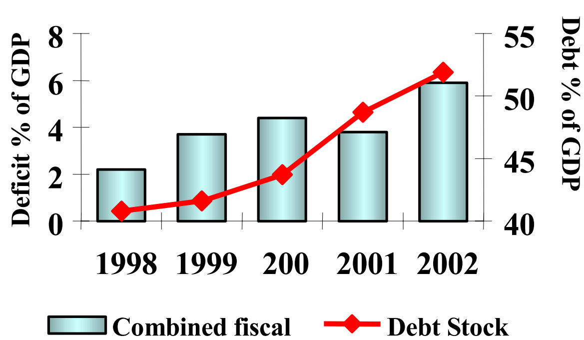
Figure 1.2. GDP growth and disposable national income (1994=100)



1.13 In the past three years (2000-2002) the Costa Rican economy has slowed (see Table 1.1), the result of sluggish global growth, declining terms of trade, and the crisis in the microprocessor market. As its macroeconomic performance faltered, Costa Rica's economy became more vulnerable. The state of the public finances—the primary chronic problem in efforts to preserve macroeconomic stability—worsened, producing a combined fiscal deficit equivalent to 5.9% of GDP in 2002. This exceeds the recurring deficits of the 1990s which averaged 3.4%. (Chapter II, section I, provides details on the fiscal situation in its description of key challenges.)

1.14 Government borrowing to manage fiscal deficits has added to the public debt stock, which after a decade of increases stood at the equivalent of 52% of GDP in 2002. The domestic debt share corresponds to 32.1% of GDP and 60% of the aggregate public debt is dollar-denominated poses a risk to the public finances. This heavy debt load is putting added stress on the fiscal deficit, public-sector interest outlays equivalent to 5% of GDP in recent years having consumed roughly one third of tax revenues.

Figure 1.3:
Combined fiscal deficit and debt stock



1.15 As the Costa Rican economy has become more diversified (the manufacturing sector now contributing more to economic activity) the country's export base has become more diversified as well. Nevertheless, the trade and current account deficits widened over the last four years, with the latter at around 5.5% of GDP in 2002, reflecting the slowing of export growth and earnings from services, the growing weight of debt-service interest in the current account, and mounting external remittances. Thanks to the country's capital market access in recent years and foreign direct investment inflows it has been able to finance the aforementioned deficits, keeping net foreign-currency reserves at low levels (2.5 months of imports at year-end 2002).[16] This dynamic underscores the Costa Rican economy's external vulnerability and reliance on external saving.

1.16 Despite the authorities' efforts to keep the real exchange rate competitive by successive adjustments under the crawling peg system, the exchange rate[17] appreciated 10% between late 1995 and 2002.[18] This, in combination with a decline in total factor productivity since mid-1995,[19] has weakened the country's external competitiveness. In addition, the macroeconomic climate and exchange-rate system have triggered a dollarization process affecting half of all banking system loans and deposits, imposing restrictions on exchange-rate policy and leaving the system more vulnerable to a devaluation.

1.17 Costa Rica's gross public sector borrowing requirements, equivalent in 2002 to around 16% of GDP,[20] have put pressure on interest rates as well. High rates push up the cost of capital for small businesses who are unable to borrow in dollars. These requirements complicate monetary policy management, since the Central Bank has to shoulder the costs of monetary expansion generated by public sector deficits while sterilizing the inflow of short-term capital attracted by the high interest rates.

1.18 Until very recently Costa Rica was able to tap the capital markets with a Standard & Poor's long-term external debt rating of BB,[21] but in April 2003 S&P downgraded its outlook for the country from stable to negative.[22] Changes in balance-of-payments capital account flows stemming from a shrinkage of external financing, dwindling foreign investment, and a sudden stop in capital inflows would make it very difficult for the country to fund the current deficit and would require a swifter, more drastic fiscal adjustment, dimming the country's growth prospects.

D. The macroeconomic outlook

1.19 Prospects for Costa Rica's macroeconomy from 2003 to 2006 will depend on the new administration's success in paring the public sector deficit, on the international climate, on how well the country profits from the opportunities afforded by new trade agreements, particularly the Central America-U.S. free trade accord (FTA-CA), and on the gains achieved by way of structural reforms[23] that affect the competitiveness of the nation's production sectors. Table 1.1 presents two scenarios that differ based on the policies implemented by the government. The same international conditions[24] are assumed for both scenarios.

1.20 The low scenario describes an internal climate in which the policies were unable to meet the challenges facing the Costa Rican economy. The policies are limited to the implementation of the fiscal emergency act (transitional), and no permanent laws are approved or implemented. Under this scenario, beginning in 2004, fiscal deficit growth resumes, compromising macroeconomic stability and, in particular, discouraging external investment. The increase in the deficit generates a crowding out effect on domestic investors, makes it impossible to lower inflation, and limits the acceleration of economic growth. As a consequence, GDP grows at an annual rate below the level of the last decade, remaining at 2.5%, comparable to the last three years, despite a partial recovery of the world economy. The public debt situation continues to deteriorate.

1.21 The high scenario describes the results of the application of permanent fiscal deficit reduction policies combined with the implementation of proactive policies for global economic integration. The cut in the fiscal deficit is achieved through a policy package designed to strengthen fiscal discipline. The estimates assume a gradual narrowing of the combined public sector deficit to the equivalent of 1.7% of GDP in 2006, ensuing from a reduction in the central government deficit. That fiscal effort would reduce the public debt stock by close to seven percentage points of GDP, to stand at 45% of GDP by the end of 2006. The policy for global economic integration, in particular the FTA-CA, provides for a series of actions to go support the movement toward a more open economy and boost the competitiveness of domestic firms, with a particular effort in the direction of the SMEs. Costa Rica's sources of growth will continue to be high technology industries and the local suppliers of those firms. As a result of the application of the reforms, these firms will forge stronger productive linkages with the free zone export businesses. Other sources of growth include tourism and the SMEs that participate in the nontraditional goods and services export clusters.

1.22 A central feature of this scenario is sounder public finances, which in turn will open up more avenues for private enterprise. If this goes hand in hand with a proactive economic adjustment policy and continuing moves to open its economy, Costa Rica could profit more from its inroads into the global economy. In this scenario, fresh investment, including heightened private sector involvement in infrastructure, and the surge in exports anticipated from the FTA-CA could make for 4%-4.5% annual growth in 2005-2006 and bring inflation down to 7% in 2006.

1.23 Increases in exports and improvements in the terms of trade are expected to narrow the balance-of-payments current account deficit to 4.6% of GDP by 2006. Private-sector-led gross domestic investment would climb from 18% of GDP to 20% of GDP over that interval, while a substantial increase in public saving would push up gross domestic saving.

1.24 Costa Rica has been able to go into the capital markets[25] since 1997 and hence has been able to mute the impact of external financial shocks, but any sudden stop in capital inflows to the subregion—always a possibility—would hurt the country's external financial position and public accounts. Successful implementation of the country strategy will help to substantially lower that risk by bolstering the public finances, reducing the public debt and enhancing its financial terms and conditions, and attracting direct investment. This effort will be underpinned by the application of the IDB Group's range of instruments, which offer the added benefit of synergies that stem from: (i) coordinating operations of the public and private sector windows and with the activities of other multilateral and bilateral organizations; (ii) offering technical cooperation funding to support institutional strengthening and consensus-building and will help prepare operations; (iii) fostering intellectual exchanges through research work and seminars by means of financing nonfinancial products; and (iv) providing the additionality of ensuring that new operations will complement those already under way.

Table 1.1. Macroeconomic performance and outlook 2000-2006

Percentage variation (unless otherwise indicated)	**Results**			**Projections – High scenario**				**Projections – Low scenario**			
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**
Real GDP growth	1.8	1.1	2.8	2.2	3.5	4.0	4.5	2.0	2.5	2.5	2.5
Disposable national income	1.4	2.8	2.8	1.3	3.2	3.8	4.5	1.3	2.5	2.0	2.5
Consumer price index	10.3	11.0	9.7	10.0	9.0	8.0	7.0	10.0	10.0	10.0	10.0
Per capita GDP in dollars	3753	3903	3904	3900	4057	4241	4456	3900	4018	4139	4263
As a percentage of GDP (unless otherwise indicated)											
Combined public sector	-4.4	-3.8	-5.9	-4.0	-3.0	-2.1	-1.7	-4.0	-4.7	-5.3	-5.4
Central government	-2.7	-2.6	-4.5	-3.9	-2.9	-2.1	-1.6	-3.9	-4.5	-5.2	-5.2
Rest of nonfinancial public sector	1.1	1.3	0.6	1.2	1.2	1.3	1.3	1.2	1.2	1.3	1.3
Central Bank	-1.8	-1.2	-1.4	-1.3	-1.3	-1.3	-1.4	-1.3	-1.4	-1.4	-1.5
Public debt stock	43.7	48.7	51.9	51.8	50.4	48.1	45.2	51.8	52.0	52.7	53.3
Domestic	24.0	28.9	32.1	31.4	32.4	31.5	30.5	31.4	33.4	34.7	35.9
External	19.7	19.8	19.8	20.4	18.0	16.6	15.2	20.4	18.5	18.0	17.4
Balance of payments current account	-4.7	-4.5	-5.5	-5.3	-5.1	-4.8	-4.6	-5.3	-6.1	-6.4	-6.8
Net international reserves (months of imports)	2.3	2.0	2.4	2.2	2.3	2.4	2.5	2.2	2.3	2.1	2.1

Sources: BCCR, IMF, IDB estimates.

1.25 The above diagnostic assessment heads to a clear conclusion: immediate decisions would be required to right the country's fiscal imbalances. The new administration quickly brought in interim measures to trim the fiscal deficit,[26] but permanent measures are needed. The consensus-driven decision-making process that is a Costa Rican fixture needs to be given special attention and support since this process could lead to delays in adopting such measures, which could jeopardize fiscal sustainability.

II. KEY DEVELOPMENT CHALLENGES

2.1 At the heart of the challenges facing Costa Rica is the need to **accelerate economic growth**, as a sine qua non for continued improvements in living standards in a socially cohesive and harmonious society when mounting competition in the global marketplace is making efficiency improvements imperative.

2.2 The two preeminent drivers of growth will be: (i) competitiveness improvements in goods and services production and (ii) investment in physical and human capital. Since 1995 Costa Rica has seen a decline in the contribution by total factor productivity to trend growth, with no change in capital's contribution to trend growth.[27] Fixed investment has been on the decline, slipping below 18% of GDP in the last three years. This is barely the Central American average and sits well below the figures reported by more buoyant economies.[28]

A. Development challenges: The competitiveness imperative

2.3 The country's development agenda speaks directly to the challenge of making its goods and services production more competitive. This will call for cross-cutting, cross-sectoral actions in areas of the economy that have a part to play in growing Costa Rica's production apparatus. The actions that will be required of government and private enterprise on these fronts can be grouped under two overarching challenges: (i) consolidate the macroeconomic environment and (ii) accelerate production growth to make the most of the global market opportunities afforded by trade agreements and treaties, particularly the FTA-CA, and the integration process. These two challenges are very closely intertwined but to facilitate the analysis they will be examined separately here.

1. Consolidate the Macroeconomic Environment

2.4 As was noted above, in the last 10 years Costa Rica's macroeconomy has been characterized by recurring public deficits, which climbed from an average of 3.4% of GDP in the 1990s to 5.9% in 2002. There is a widespread consensus in the country that the fiscal deficit is a serious impediment to growth, since the imbalances it generates push up interest rates, crowding out private sector investment, raising inflation, and leaving the economy more vulnerable as domestic saving declines and the country becomes more heavily reliant on external finance. That broad consensus is reflected in the Fiscal Reform Agenda crafted by an ad hoc committee of former finance ministers, which was the starting point for the shaping of the National Development Plan unveiled by the new administration.

2.5 Costa Rica's fiscal revenues are insufficient for a country at its level of economic and human development. Its *low tax burden*[29]—the result of a complex, regressive taxation system with multiple exemptions—means low revenues for the treasury. The schedular income tax system (taxing income by source) operating on the territoriality principle makes for differential tax treatment and thus creates inequity. Exemptions allowed for businesses operating in the free trade zone have narrowed the tax base. The sales tax has a cascading effect: changing it to a value added tax would boost yields and make this levy easier to administer.

2.6 The country's chronic fiscal deficits can be attributed to *significant public spending rigidities* explained in some measure by: (i) the high percentage of revenues that are earmarked by law (close to 40% of central government tax revenues are earmarked—only 6% of such set-asides being constitutionally mandated for the judicial branch[30]); were all of these earmarkings to be applied, the government deficit would increase in 2003 by close to 2%; and (ii) payroll costs for a complex civil service system featuring automatic seniority adjustments and earnings multipliers, plus the need to add positions to deal with rising enrollments (about 3,000 more positions a year). These costs, added to pension outlays and interest payments on the public debt, represent over half of aggregate public expenditure, equivalent to 12% of GDP.[31]

2.7 The pension funding system is another strain on the treasury. Though the Costa Rican Social Security Administration (CCSS) is currently posting an operating surplus and has accumulated reserves equivalent to roughly 7% of GDP, CCSS forecasts show the current pension system to be unsustainable in the long run. Since pension outlays are rising more quickly than contributions, within 20 years the system will be running a loss and quickly eat up its reserves.

2.8 The new administration is ascribing top priority to fiscal discipline. Toward the end of 2002 the legislature passed the **Fiscal Contingency Act** and an executive order announced the **Public Expenditure Rationalization Plan.** These interim measures (in effect only for 2003) are expected to boost revenues by 1% of GDP and cut spending by 2% of GDP. They include increases in personal and corporate income taxes, excise taxes and selected rates, tax administration improvements, and caps on spending and wage increases.

2.9 The government also has sent a package of draft legislation to the Legislative Assembly, with bills regarding: (i) income tax reform; (ii) changing the present sales tax to a value-added tax; (iii) curbs on new public borrowing; (iv) elimination of distortions and abolishment of minor levies; (v) strengthening of tax administration by creating a National Taxation Directorate, a minimally deconcentrated agency attached to the Ministry of Finance with jurisdiction for customs, taxation, and a fiscal police corps; and (vi) rewriting of tax code and commercial code rules and procedures.

2.10 Efforts at the central government level need to be mirrored in public enterprises and subnational governments. Though overall Costa Rica's State-owned enterprises are running surpluses, they are not generating enough savings to come up with the capital investment needed to make the economy more efficient. Compounding the falloff in investment are rising current expenditures in these companies, driven by salary increases. The public finances need to be modernized at the municipal government level as well, to bolster local government revenue-generation capabilities, make municipalities less dependent on central government transfers, and help improve efficiency and control spending.

2.11 Strengthening the public finances is the centerpiece of Costa Rica's macroeconomic agenda. A reduction in the fiscal deficit will lessen the pressure on domestic financial markets by easing the crowding-out of the private sector that occurs when public sector borrowing requirements push interest rates up to high levels. Tighter fiscal discipline also will lower the risks to the economy and make it less vulnerable by creating conditions for price stability and leaving the country less reliant on external saving, with the concomitant paring of the public debt.

2.12 In an investment-friendly macroeconomic environment public expenditure will become more efficient, helping to enhance the competitiveness of productive activities and opening more avenues for private investment to help propel economic growth.

2. Accelerate production growth to seize global integration opportunities

2.13 External demand being the prime driver of growth in Costa Rica's very open economy,[32] the country finds itself competing with highly advanced economies. In the new liberalization chapter that will be opening for Costa Rica and for the Central American region with the series of trade agreements now on the negotiating table (FTA-CA, FTAA, and FTA-EU),[33] the deepening of the Central American Common Market, and the Puebla-Panama Plan, the country will have new opportunities to position itself internationally. The new climate will demand institutional improvements and swift production-sector adaptation to a new competition environment.

2.14 A multitude of factors come into play for the development of Costa Rican production and competitiveness of the country's goods and services. Among the most important are: (i) the national and local growth climate; (ii) the cost of doing business in the country; (iii) production-related factors; and (iv) sustainable development of the rural economy, particularly the agriculture sector.

a. Creating a pro-growth environment

2.15 Though Costa Rica ranks at or near the top of governance indexes for Latin America,[34] the need to assure fiscal sustainability and contend with a shifting international environment as new integration agreements take shape calls for a rethinking of the Costa Rican public sector's organizational and operating model.

2.16 The problems of the State in Costa Rica resemble those facing the advanced democracies. It is striving to adapt the apparatus of government to the new economic and political environment so they can continue to foster economic growth and social cohesion.[35] For Costa Rica this would mean developing a model that gives private enterprise more of a role in attending to social needs. This transformation must take into account Costa Rican society's traditional resistance to change, which in part reflects its level of satisfaction with the services provided by the state.[36]

Box 2.1. Costa Rica and its integration into the global economy

Costa Rica's strategy to position itself more solidly in the global marketplace has pursued both a multilateral and regional focus. The country joined the GATT in the late 1980s and now is a full member of the World Trade Organization; it is a founding member of the Central American Common Market (CACM) and an active party to the Free Trade Area of the Americas (FTAA) negotiations. It has concluded free trade accords with Mexico, Panama, the Dominican Republic, Chile, and Canada, and will soon be signing a free trade agreement with the Caribbean Community.

Though it is a staunch advocate of regional integration, Costa Rica is not making the most of CACM opportunities: its intraregional trade accounts for just 10% of its total foreign trade.

In the Bank's opinion, the FTA-CA poses major challenges for the Costa Rican government, associated with the opening up of the services sector, particularly the financial and telecommunications sectors that are still State-run. An evaluation also will be needed of investment incentives and export laws and regulations, particularly for free-zone operations, as will a review of excises and local rates and taxes.

Implementation of the FTA-CA will require the country to step up institution-strengthening efforts, improving customs procedures and instituting health, phytosanitary and standards-related measures.

To profit fully from the opportunities opened up by the FTA-CA, Costa Rica will have to enhance its investment and business climates, promote SME competitiveness improvements and support production realignment initiatives, especially in the rural sector.

2.17 Costa Rica's regulatory environment has become burdensome for business and for society at large. Though the country has made major strides in streamlining bureaucracy, it still sits next to the bottom in the World Economic Forum's ranking of business's perception of the burden of regulation.

2.18 For the economy to grow, the private sector's transaction costs will need to come down. According to the World Economic Forum (WEF) Costa Rica ranks 55th among 80 countries for number of days needed to start a business (120 days in the baseline year 2002). Business startup costs also are relatively high (position 40 on a list of 80 countries). This will mean modernizing the State, strengthening the paperwork reduction office of the Ministry of Economic Affairs, Commerce and Industry, and assuring the application of legislation modernizing the Bureau of Unfair Trade Practices and Safeguard Measures. The government also should assure competition and free entry into commercial activities, strengthening the Competition Policy Commission and Consumer Protection Office. On the foreign trade side there is a need to monitor commercial activity, administer trade, and coordinate the work of agencies with responsibilities in this sphere.

2.19 Shaping a pro-growth environment is a medium-range task in which the private sector also will figure prominently. Costa Rica recently created a National Competitiveness Council but has yet to devise an institutional mechanism to move from dialogue to a workable long-range strategy and identify roadblocks to growth in each sector of the economy.

2.20 Though Costa Rica stands as an example for the region in the sphere of justice administration, it has at least two problems to resolve: (i) the length of time it takes to settle a dispute, and (ii) deteriorating quality of life in cities. On the first point, dispute resolution takes about one year, which puts Costa Rica in 59th place on a list of 80 countries examined (according the WEF). On the second point, the crime rate is on the rise, making it necessary to bolster the law enforcement and prevention sides. Since cities are key to attracting economic activity, a deteriorating urban habitat can dampen growth prospects. Behind such declines are unregulated urban sprawl (situations of poverty and marginalization, fraying of social cohesion, high transportation costs, pollution, and delinquency, among other factors). It is important that an enabling environment be in place, including protection for vulnerable populations and universal access to services and development opportunities.

b. The cost of doing business in Costa Rica

2.21 According to a cost-of-doing-business analysis, *logistical costs* are lower in Costa Rica than elsewhere in Central America but higher than in global competitors, whereas the country's *financial costs* are high even by regional standards.

(i) Logistical costs

2.22 Over the past two decades infrastructure investment in Costa Rica has fallen significantly behind. In the ***transportation sector***, the combination of modest investment (such outlays being dependent on the treasury), maintenance and planning system problems, and administrative inefficiencies have left the nation's transport infrastructure in poor condition, making transportation expensive for users and impairing Costa Rica's competitiveness. Only 17% of the arterial road network (which constitutes 20% of the country's road system) is in good repair. The situation of local roads (80% of the national network) is much worse: less than 5% of this system is in good condition.

2.23 Costa Rica has been endeavoring to increase private sector participation in road, port, and airport finance by way of concession contracts, but thus far has made some measure of progress only in the airports subsector. Given the heavy capital investments and efficiency improvements that will be called for in the coming years in an era of fiscal restraint, private enterprise will have to play an ever increasing role.

2.24 In the ***telecommunications sector***, the country has achieved a basic telephony density ratio well ahead of the Latin American average, but its basic and cellular telephony capacity cannot keep up with the overwhelming demand. Improving efficiency in this sector would mean removing restrictions on entry of new carriers and service providers, upgrading service quality, using market-based pricing and assuring the business viability of the electric power authority (Instituto Costarricense de Electricidad—ICE) in the industry's new technological environment.[37] The Costa Rican State has decided to leave telecommunications services in government hands, bolstering ICE's institutional capacity.

2.25 In the ***electricity sector*** Costa Rica has been posting acceptable coverage ratios, per capita consumption levels, and service management and delivery performance compared to other countries in the region, but the decline in investment in the ICE has begun to impact its growth capacity, notably as regards capital outlays required to keep the distribution grid in sound condition. It will be important to encourage private sector participation to help rid this sector of inefficiencies, such as the dearth of high-tech investment, which is keeping commercial and industrial rates high and causing frequent power interruptions and voltage fluctuations. As in the telecommunications sector, the State is keeping electricity services in the public sector arena. There are only a handful of private providers, among them rural electrification cooperatives.

(ii) Financial costs

2.26 Financial costs in Costa Rica are higher than elsewhere in the region, in the form of high interest rates, large intermediation spreads (a consequence of the structure of the financial system), and the macroeconomic risk.

2.27 Though the Costa Rican financial system features a high degree of intermediation, with assets equivalent to 72% of GDP (77% of aggregate financial system assets are held in banks), intermediation services are heavily concentrated in four banks—three of them publicly owned—which together account for 60% of the total deposit base. This, in a system made up of 18 private commercial banks, 3 State banks, 26 regulated credit unions, 3 savings and loans institutions, and about a dozen private finance corporations.

2.28 Government-owned banks are undercapitalized and have advantages over private commercial banks (exclusive deposit insurance, mandatory commercial-bank funding of public banks).[38] This stifles competition and creates inefficiencies that spill over into the rest of the system, for instance in the form of wider intermediation spreads.[39] Though the Superintendency of Financial Institutions (SUGEF) made major strides last year in instilling and improving consolidated-supervision principles, a host of issues still need to be addressed for truly effective consolidated supervision. Another consideration is that SUGEF lacks full regulatory enforcement authority, since not all its recommendations are binding. This issue is moving front and center as the offshore financial industry grows.

2.29 Costa Rica has yet to firm up a national capital market development strategy built around a liquid market for government debt securities. The dominance of the insurance industry by a State monopoly, the National Insurance Institute, has held back product innovation and weakened that industry's impact on long-term saving generation.

2.30 In addition to the need to maintain a stable, sustainable macroeconomic environment, the Bank feels that financial-system requirements include further capital market development, financial viability and strengthening of the three pillars of the pension system,[40] and insurance-sector liberalization.[41]

2.31 Small and medium-sized enterprises (SMEs)[42] are a mainstay of the Costa Rican economy: they make up 95% of the nation's business community, contribute 28% of GDP, account for 80% of all manufacturing jobs, and generate 50% of total employment earnings. Their preeminent role at home contrasts sharply with their modest presence in the international marketplace. The 62% of export firms that are SMEs accounted for barely 13% of total export sales in 1999, the bulk of these being to Central America and the Caribbean (which are uncompetitive markets) from a narrow product base, largely agricultural and food items.

2.32 One of the most serious problem facing SMEs is their difficulty in obtaining credit, business development services, new technologies (including information technologies), and market information. They also must contend with a risk-averse financial system and a high degree of informality.[43] It thus is crucial to develop financial and support products that can help SMEs move into the export market while remaining firmly positioned on the home market, which with deepening trade liberalization promises to become much more competitive.

c. Production-related factors

2.33 Productivity in Costa Rica is keyed to the quality of factors of production—inputs into productive processes—which will hinge on the caliber of the country's **human capital** and on business's adoption of production technologies.

2.34 A review of the state of human capital formation in Costa Rica reveals that, though the country has made major strides in **education**, having attained a very high literacy rate, virtual universal primary education, and steady increases in secondary education coverage, inefficiencies in the system are affecting its performance. Repetition rates are high—over 16% of students repeat a grade between first and seventh grade—as are dropout rates, particularly in seventh and ninth grade. School completion is a concern as well: only 33% of 20-year-olds have made it through high school (half the Colombian and Chilean figure). The school system still does not reach many low-income and rural children and youth.[44]

2.35 Though Costa Rica's education spending as a percentage of GDP stands above the Central American and Latin American regional averages, current expenditures take up over 90% of the total, budgetary management is highly centralized, and there are systemic inefficiencies, so education outcomes are not commensurate with education outlays.[45] The chief challenges for the country in the education sphere are to have the system reach lower-income populations and strengthen secondary education, expanding coverage, improving quality, and designing job-market-oriented curricula.

2.36 **Health sector** efficiency has improved thanks to sweeping institutional changes that boosted productivity and made services more widely available while lowering unit costs. There still are some weaknesses in the sector, particularly in primary care: an estimated two thirds of hospital outpatients could be treated by primary care practitioners. Though 90% of the population have health coverage, 30% of the poor are encountering access difficulties and there are sharp regional disparities as well.[46] The government's health strategy is expected to gradually move the system from its eminently curative focus to one emphasizing prevention and health promotion. One challenge for the system will be to expand its reach to take in people in every income bracket across the country.

2.37 A relatively high percentage of Costa Ricans have **piped water service** (98% in cities, 75% in the countryside) but only 22% of the population have sanitary sewer service and 96% of the sewage collected is being discharged, untreated, into rivers. To improve efficiency in this sector the regulatory agency (ARESEP) will have to be strengthened and avenues for private sector involvement in service delivery devised, making sure that operators invest in sewage treatment and disposal facilities.

2.38 Despite the increase in Costa Rica's **housing** stock, which has given the country one of Latin America's highest home ownership ratios (75%),[47] there still is a severe housing shortage[48] and the existing housing stock is deteriorating (13% of dwellings are in poor condition). Among the policy measures needed to address these issues are improvements in mortgage market efficiency, in subsidy targeting, and in resource allocation for improvements to the present housing stock.

2.39 Costa Rica's enormous **science and technology potential** has helped it attract major investments such as INTEL, Abbot Laboratories and Procter and Gamble. The 2002 Growth Competitiveness Index ranks Costa Rica third for the technology component in Latin America, after Chile and Brazil.

2.40 To help the production sectors bring in modern technology the country will need to: (i) get ready for electronic/digital communication;[49] (ii) improve the quality of preuniversity mathematics, English, and science instruction; (iii) gear the work of science and technology research centers more closely to priorities of the business community, particularly SMEs; (iv) innovate, adopt and adapt technology for production by spurring investment in science and technology (0.37% of GDP);[50] and (v) promote women in scientific research and new technology development.

d. Sustainable rural development

2.41 The rural economy is crucial to Costa Rica's development for three reasons: (i) the population is concentrated in rural parts of the country (over 50% of the total); (ii) poverty is higher in rural areas; and (iii) agriculture and tourism are placing a strain on the rural environment, which includes conservation areas, national parks, and biological preserves.

2.42 As new trade agreements take effect the rural economy will find itself facing fresh challenges, since the liberalization measures will impact a number of agricultural products particularly. A new strategy is needed to help these sectors adjust and shift to new products that offer comparative and competitive advantages. Agriculture contributes over 10% of national GDP, accounts for one quarter of export earnings, and gives employment to over 15% of the active labor force. The combination of falling prices for traditional export commodities like coffee and bananas and high production costs for those crops has stalled growth in these two sectors. Strategies thus need to be devised to realign production in low-productivity areas of the country, bring down marketing costs, and develop differentiation strategies for coffee. A further requirement will be a trade strategy to address import barriers to agricultural products in certain markets.

2.43 To successfully expand its tourism industry and make the gains sustainable, Costa Rica will have to pursue an environmental agenda. Consultations are currently under way to forge a consensus on such an environmental roadmap. A concurrent requirement will be to strengthen central and municipal government institutions to create an incentives framework that can ease the strain being placed on the environment.

B. The government's strategy

2.44 The overarching strategy aim of the Costa Rican government, as set out in its *2002-2006 National Development Plan* (NDP), is to combat poverty, pursuing five intertwined action focuses: (i) human capacity formation and development; (ii) production incentives and growth to create employment; (iii) environmentally-friendly growth; (iv) citizen security and justice administration; and (v) transparency in government, citizen participation, and external relations and international cooperation.

2.45 The goal of the ***human capacity development*** action focus is to raise Costa Ricans' living standards by way of a more equitable sharing of opportunities. The ***production incentives and growth for employment creation*** focus will pursue macroeconomic stability, promote productive-sector competitiveness to deepen liberalization and integration, and create wealth with which to combat poverty.

2.46 In its pursuit of ***environmentally-friendly growth*** the NDP will foster a culture of respect for and harmony with nature and rational use of natural resources. To preserve national sovereignty and social peace, the plan's ***citizen security*** and ***justice administration*** components include measures to prevent and control crime, curb corruption, control migratory flows, combat drugs, and improve justice system efficiency.

2.47 The object of the ***government transparency, citizen participation, and external relations and international cooperation*** action focus is to enhance the workings of government and public services by fostering public-participation entry points and avenues and continuing with moves to modernize the State.

2.48 This is an ambitious plan encompassing multiple sectors, but the level of detail it contains on the proposed activities and the concrete targets set in each case will facilitate its implementation, monitoring, and evaluation. The Costa Rican authorities have underscored that the new administration's priority is to spur growth, driven by competitiveness improvements in the production sectors.

III. ANALYSIS OF THE BANK'S PREVIOUS STRATEGY AND PORTFOLIO ANALYSIS

A. The 2000-2002 strategy

3.1 The strategy for the three-year span 2000-2002 was grounded in the National Human Development Plan unveiled by the administration of Miguel A. Rodríguez, which proposed to spur environmentally-benign economic growth and maximize the benefits of such growth for society. Drawing on the Bank's experience in its work with Costa Rica, the strategy had three core action focuses: (i) facilitate consensus-building processes; (ii) improve the loan portfolio performance; and (iii) develop new projects and activities to: (a) consolidate structural reforms; (b) modernize infrastructure; (c) develop human capital; and (d) promote foreign-exchange-generating activities, particularly those offering high added value.

3.2 Pursuant to that previous strategy the Bank has been supporting Costa Rica's efforts to: (i) identify its most pressing challenges and come up with ways to address them and (ii) build consensuses. This is an ongoing process that takes time to mature; its impacts transcend political cycles and the lifespan of strategies.

3.3 Accordingly, during the period under review the Bank Group's nonlending products focused on support for analyses of reform issues, including tax reform, modernization and opening up of the public sector, and financial system strengthening. These issues have remained on the agendas of successive administrations, which posted concrete gains at a pace that was somewhat slower than economic circumstances would have required but did preserve political equilibrium in the country.

3.4 These were difficult years for Costa Rica. As adverse global conditions slowed the country's economic growth, the state of the public finances worsened and public investment was reduced. To fund its fiscal deficits the country thus looked to readily accessible fresh funding that could secure swift passage in the legislature.

3.5 One facet of the strategy was support for ambitious reforms in the financial sector and public finances, which figured on the government's agenda as prerequisites for continued growth and efficiency improvements in the economy. Despite the government's efforts the required consensuses were not achieved and the reforms lost political viability early on, eliminating the space for the policy-based operations that had been programmed.

3.6 In those circumstances, when other multilateral organizations like the World Bank had no Costa Rica lending program, the Bank continued to help the government explore ways of advancing the reform agenda, and made its programming more flexible to provide support for land tenure regularization, initiatives to enhance agriculture sector competitiveness, and the integration of Costa Rica's electric power system with the rest of Central America (SIEPAC), with ongoing support for the justice sector as well.

3.7 One concrete outcome of the Bank's strategy, pursued by way of MIF and IIC products and the active loan portfolio, was support for the opening of avenues for private sector involvement in *infrastructure*, especially for roads and water and sanitation, by strengthening the National Concessions Council. The strategy also promoted *foreign-exchange-earning activities* through operations with microenterprises and small and mid-sized businesses in the information technology sector, as well as export operations and production of goods and services for the telecommunications industry. The achievements of the strategy objective of improving portfolio performance are described in the following section.

3.8 The Bank's nonlending products go hand in hand with the reforms, supporting a dialogue and decision-making process whose impact often will be felt in subsequent political cycles and in new strategies. Furthermore, the lengthy project maturation cycle creates resource allocation inefficiencies, delaying the reforms' benefits and lessening projects' development impact and lowering their returns.

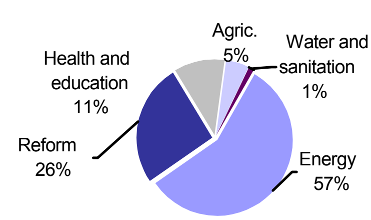
3.9 The time lag between achieving consensus and gaining acceptance for reforms makes it particularly difficult to compare the impact of products deployed in the previous strategy against the indicators matrix identified therein. Most of the interventions were associated with reform processes the approval and implementation of which can be attributed only to a limited extent to the Bank. Progress was achieved on partial reforms with support from programs launched during previous cycles that were in progress at the time, for instance financial sector and tax administration reforms,[51] whose impact will be felt in the new programming cycle.

3.10 Bank-supported activities over that interval also helped improve social services delivery, particularly in the education and health care systems; electricity generation and the framework for electric power integration and progress on the study and analysis of sector reforms; and strengthening of the budget process and public sector performance assessment, among others.

B. Portfolio performance

3.11 There are 10 projects in the Bank's Costa Rica portfolio,[52] four of which—accounting for 29% of the undisbursed balance—were approved in the 2000-2002 period.

Figure 3.1 : Sectoral breakdown of active loans (undisbursed balances)

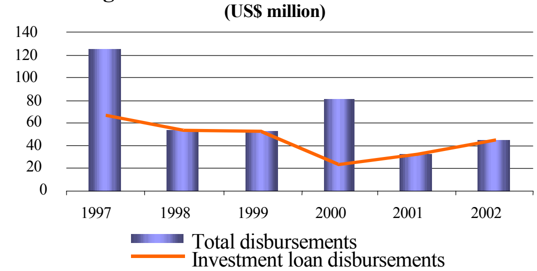


The following is their sectoral breakdown: energy 57%, modernization of the State 26%, health and education 11%, agriculture 5%, and water and sanitation 1%.

3.12 Though loan execution has been slow, with completion times averaging eight years, 90% of the projects are rated highly likely to achieve their development objectives. Six of the eight projects completed in the last five years did attain their objectives and targets.[53]

3.13 During the previous strategy period the portfolio performance improved significantly, moving from one problem project and six operations on the watch-list at the beginning of 2000 to three watch-list projects at the end of 2002. The reformulation of two loans, improved performance of education and health projects, and the start of disbursements for four projects approved in 2001-2002 will maintain the upward trend in investment loan disbursements recorded since 2001. The ratio of disbursed to undisbursed loan proceeds in 2002 was 13%.

Figure 3.2. 1997-2002 disbursements
(US$ million)



3.14 Part of the explanation for the slow implementation pace is the time it takes for loan contracts to enter into effect, since each loan requires legislative approval (qualified majority)[54] followed by another wait until the budget law authorizing the use of funds is passed (simple majority). For currently active loans, about 30 months elapsed, on average, between loan approval and declaration of eligibility. Other factors slowing loan execution are: (i) protracted tendering processes owing to frequent appeals; (ii) local counterpart shortfalls because of fiscal constraints; and (iii) weaknesses in executing agencies' institutional capacity, accentuated by high personnel turnover.

Box 3.1. *Lessons learned from the portfolio performance*

In light of the time it is taking to fulfill conditions precedent, project quality at entry needs to be improved, using designs that simplify preconditions and expedite internal formalities for project launches.

Efforts to adjust and update the active loan portfolio to match country priorities also need to be stepped up to ensure that the portfolio continues to be relevant.

3.15 There currently are 25 technical cooperation operations in the portfolio, 14 of them regional projects or programs, with US$6.8 million still undisbursed. During the 2000-2002 strategy period the Bank approved 14 technical cooperation projects in pursuit of its strategy in areas such as agricultural development, trade, infrastructure, microenterprise, and human capital development. Two small projects and associated technical cooperation approved over that interval to further microenterprise development are still under way.

3.16 The MIF portfolio consists of 13 projects with an undisbursed balance of US$6.8 million, including four regional operations. In addition, three funds currently operating in the country (CFA, E&CO and Ecoempresas) have arranged nine deals totaling US$3.1 million. Eighty-five percent of the operations are rated highly likely to attain their development objectives; implementation progress is judged to be satisfactory in over half of them. In some cases it has taken longer than planned to implement the projects since they involve innovative areas like biodiversity, tourism, software, and high-tech ventures and the agencies that were needed to implement them had no development-project experience.

3.17 Three regional operations and two country projects were approved in 2000-2002. One of the country operations, still in progress, is supporting microenterprise; the other was canceled because of changes in the finance environment for small agricultural producers. Costa Rica is taking part in five recently approved regional operations involving PPP sectors, institution of phytosanitary measures, competitiveness, customs modernization, and sharing of experiences among Central American development banks.

3.18 The Bank's Private Sector Department (PRI) has no operations in Costa Rica at present. The final disbursement of a loan for the Miravalles III geothermal plant in the northwestern region of Guanacaste was released in 2000. One constraint for project development in Costa Rica has been the small size of operations, which increases appraisal costs. The institutional framework for concessions needs strengthening, and local technical expertise needs to be improved.

3.19 The IIC has been very active in Costa Rica, with satisfactory portfolio performance. Five operations were formalized during the period reviewed here—two directly with Costa Rica (Condicel and Banco Improsa) totaling US$10 million and three Central American/regional ventures.[55]

Box 3.2. The IIC in Costa Rica

The IIC recently released the final disbursements for six operations totaling US$33 million to build hydroelectric plants, open long-term credit lines in commercial banks for SME finance, and construct and manage a hotel, as well as an operation with a telephone company to fund the installation, maintenance and leasing of 15,000 telephone lines.

US$27 million in financing was provided for four Central American/regional investment funds. The benefits to Costa Rica of these funds come to US$18.2 million in operations arranged thus far.

3.20 Substantial progress has been made on building capacity to execute multilaterally funded loans. A first key step was to create a Support Unit attached to the Ministry of Finance to serve as liaison between that ministry, the Bank, and executing agencies, expediting the flow of loan proceeds and coordinating capital investment programming to ensure that budget funds are duly allocated. The Unit also provides assistance related to legislative ratification of loan contracts and the launch of new operations.

3.21 Goods and services procurement is a second front on which appreciable gains have been achieved, with tighter coordination between executing units, the Comptroller General's Office, and the Bank to make national procurement legislation and the

Bank's procurement rules and policies consistent. Close contacts between the Country Office's Standing Advisory Group on Procurement and executing units, the Comptroller General's Office, and the Bank's Procurement Unit are expediting decision-making.[56]

3.22 Other noteworthy activities were the restructuring and cancellation of balances in some problem projects, courses organized under the Training Program for the Group C and D countries to strengthen executing units' capacity, and the continuation of portfolio review missions and target-setting to further improve performance.

C. Evaluation of the Bank's country program

3.23 The Bank's Office of Evaluation and Oversight evaluated the 1990-2001 Costa Rica country program, which took in the first two years of the Bank's most recent country strategy (2000 and 2001). While affirming the strategy's value the study points up a number of problems regarding the country program's consistency, efficiency, and effectiveness owing to the absence of the requisite consensuses to carry through the reforms envisaged in the strategy.

3.24 The following are the recommendations that came out of that evaluation, which were referenced in designing the new country strategy:

(i) *Work with stakeholders to develop the dialogue and pave the way to a programming consensus; ensure also that the programming focus takes account of political viability considerations*. The BSCR is the fruit of continual, extensive consultations with the government. The mutually agreed diagnostic assessment that came out of those discussions is the basis for the outline of development challenges presented in this paper. The fact that the reforms slated for BSCR support, notably fiscal reforms, have been discussed at length in the country augurs well for their political viability. The starting point for the discussions was the report from the committee of former finance ministers. Out of this dialogue came a consensus that resolving the fiscal problem was a top priority. As its contribution to this consultation process the Bank provided funding and led a workshop on tax reform with members of the Legislative Joint Committee, civil society representatives, and government officials. Likewise, all the Bank operations designed to help further reforms will include support for consensus-seeking among stakeholders.

(ii) *In the new programming exercise, include flexible, performance-based lending products.* During the period of the strategy, the Bank will consider flexible, performance-based methods of intervention. A recommendation was supported by the Board of Executive Directors that the modality be applied in Costa Rica on a pilot basis, inasmuch as it has been requested by the government.

(iii) *Synchronize the programming/strategy with the political cycle*. In an effort to match programming cycles more closely to political cycles, the Bank will endeavor to give high priority to loan approvals at the start of the political cycle. It also will keep conditions precedent to a minimum, seeking instead to have such conditions fulfilled before an operation is approved.

(iv) *Speed up adjustments in loan programming and implementation*. Previous sections of this paper describe proposed Bank-supported measures to improve loan execution, including the strengthening of procurement processes, strengthening of executing agencies using Group C and D funds, and creation of a Support Unit within the Ministry of Finance.

(v) *Tap Bank Group synergies*. The strategy explicitly proposes to maximize synergies among the Bank Group's various public- and private-sector windows, coordinating activities to heighten their impact and coordinating also with the work of other development cooperation providers.

(vi) *Shorten approval processes*. Taking a proactive stance in this regard, the Bank has offered suggestions to the government on ways of shortening the time it takes to ratify loan contracts and approve a national budget line for them. The Bank will monitor developments on the government's pledge to speed up this process in the legislature, where the government is seeking global borrowing authority for Bank programs.

IV. THE BANK'S OBJECTIVES AND STRATEGY AND THE AGENDA FOR DIALOGUE

A. Objectives

4.1 The starting points for the Bank's new strategy with Costa Rica presented here are lessons learned in pursuing the previous strategy, the new administration's priorities, and the international environment that is changing as integration processes deepen. The strategy also takes account of the Bank Group's comparative advantages to help the country tackle the challenges that await it over the next four years. With that in mind, the strategy envisages a new form of relationship with the country to address a twofold need: propel changes that are imperative in the present economic and social circumstances in tandem with the internal processes embodied in the successful *social compact* that has the backing of Costa Rican society.

4.2 The Bank's strategy is grounded in the government's *National Development Plan* with which it shares the **long-range goal** of *reducing poverty* as well as **medium-**

range goals of *sustainable growth driven by competitiveness improvements in the framework of the new trade agreements.*

4.3 Accordingly, echoing the previous strategy's aim, the objective of the Bank's 2003-2006 strategy with Costa Rica is to help accelerate economic growth as a sine qua non for improvements in living standards and for poverty reduction, particularly among female heads of household and Afro-descendant and indigenous communities, which are the poorest segments of the population.

4.4 As the Bank has learned from its experience in Costa Rica, the unique features of the country's decision-making approach make it necessary to build directly into the strategy objectives a series of activities to foster dialogue and consensus-building and improve program implementation. This will assure the strategy's efficiency and effectiveness.

B. Strategy focuses

4.5 In pursuit of the objectives outlined above, the twin focuses of the Bank's strategy with Costa Rica are as follows:

- *Strategy focus I:* Consolidate macroeconomic stability.
- *Strategy focus II:* Accelerate production growth to seize global integration opportunities.

4.6 The point of convergence of these mutually reinforcing strategy focuses is the need for a more competitive production apparatus. A more stable macroeconomy will create a pro-investment environment to boost both private investment and production-sector competitiveness. This will make for more robust growth and healthier macroeconomic accounts.

1. Strategy focus I: Consolidation of macroeconomic stability

4.7 Fiscal discipline will be crucial for lasting macroeconomic stability in Costa Rica, as was discussed earlier in the "Challenges" section in chapter II. The Bank's strategy with Costa Rica (BSCR) will support the government's efforts to carry through sweeping fiscal reforms intended to improve the public sector finances by generating revenue and achieving spending efficiency improvements needed to make public services sustainable. Fiscal discipline also will create the necessary space for private sector participation in the economy, which—together with an improved climate for economic growth—will boost investment.

4.8 The BSCR is underpinned by the consensus in place in the nation as to the need to trim the fiscal deficit. The strategy will help the government foster an informed stakeholder dialogue on the other planned reforms in order to forge the necessary **consensuses**. This process has already been launched with a workshop held with members of the Legislative Assembly to advance the discussion of the government's reform plans.

4.9 One focus of BSCR support in the above-mentioned sphere is the **modernization of tax policy.** The object of the government's proposed reforms is to institute a modern, less regressive tax system that taxes global income from all sources. The reforms also will need to take account of the emergence of new growth drivers and the opening up of the economy (almost 50% of the value of the exports come from the free zones, while coffee, banana, meat and sugar account for 13.2%). This will help the country remain competitive so it can attract investment and also create a stable revenue base consonant with its growth pattern.

4.10 The planned changes in **tax administration**, which will take in customs services as well, will reduce evasion, increase revenues and performance in the targeted areas, and bring legitimacy to the reforms. This piece of the integrated financial management system being developed will enhance monitoring and control of public sector finances. Support also will be provided for debt monitoring and debt management improvements, increasing the flexibility of the government securities market and restructuring the domestic debt profile. Improvements in customs administration are crucial in light of the trade agreements currently on the negotiating table, which make sturdier institutions imperative.

4.11 In tandem with the above activities the BSCR will support **public spending** reforms called for in the package of draft legislation sent to the Legislative Assembly for review, which will increase the elasticity and efficiency of public expenditure. This will call for further efforts on individual sector reforms, notably in the social sectors, to increase public spending efficiency and modernize the civil service to set the stage for public service productivity improvements.

4.12 Another focus of continuing support will be measures to strengthen the **budget system** as an expenditure planning, execution and monitoring tool. In combination with the proposed strengthening of the National Evaluation System, the budget-related activities will foster performance-based resource allocation. Complementary measures to modernize cash management in the public sector will make for more efficient government financial management and tighter fiscal/monetary policy coordination. This in turn will enhance financial programming and narrow the quasi-fiscal deficit.[57]

4.13 The successful implementation of the BSCR should result in the adoption of permanent measures to reduce the combined public sector deficit by way of an increase in revenues and rationalization of spending. One particular subject of attention will be the quality of the proposed fiscal adjustment and the composition of spending, assigning high priority to the makeup and efficiency of social spending.

4.14 The measure of the pipeline's impact will be given by public-finance indicators currently being generated periodically and the institutional reforms brought in to improve the workings of government and the quality of spending.

2. Strategy focus II: Acceleration of production growth to seize global integration opportunities

4.15 If Costa Rica's growth pattern is to be sustainable, its goods and services sectors need to develop quickly so they can become more competitive. Parallel requirements are linkages between export businesses and the rest of the economy and production realignments made necessary by freer trade.

4.16 The BSCR will underpin the country's efforts to tackle the challenges it faces to become more competitive in the new, more demanding trade environment that deepening integration is creating.[58] The activities posited under this strategic area revolve around two focuses: (i) creation of a pro-growth institutional environment and (ii) support for growth in productive investment.

a. Creating a pro-growth environment[59]

4.17 To pave the way for a modern public sector Costa Rica will need to intensify efforts to preserve an investment-friendly environment. The BSCR will support institution-strengthening and modernization of fiscal administration and electronic filing systems to help enhance efficiency in the tax revenue collection, customs, and cash management spheres. Introducing e-government services in the public finance arena will lower transaction costs for citizens' dealings with government and thereby augment public participation. The public sector performance evaluation system will be strengthened as well.

4.18 Other activities targeted for support are the strengthening of municipal government financial management and moves to enhance coordination of investment and public services management between the different levels of government, particularly in the roads sector. Efficiency improvements in the public sector will be fostered through institution-strengthening, support for reforms and development of environmental, housing, and water and sanitation sector strategies.

4.19 The strategy will support the institutional strengthening of public agencies that will be called upon to administer free trade agreements and trade liberalization processes. On the list of issues to be addressed are phytosanitary standards, competition promotion, environmental management strategy implementation, and institutional capacity building to equip the country to compete successfully in a more unfettered environment, with clear rules to minimize investment risks. These activities form an integral part of the strategy to enhance the business climate and spur foreign investment in Costa Rica.

4.20 Another facet of the strategy is support for the modernization of the Legislative Assembly, building institutional and technical capacity in that branch of government with the ultimate aims of improving efficiency and transparency in lawmaking and better equipping the legislature for its role as civil society's representative. The BSCR also will continue supporting initiatives to bolster legal certainty regarding investment and property ownership, improve access to justice, and simplify investment formalities.

4.21 The BSCR will support dialogues to further public sector liberalization for infrastructure and the delivery of financial and basic services. It will provide support for the requisite consensus-building processes, adapting and moving forward as the pace of the agreements achieved dictates.

4.22 Through its various windows the IDB Group will help Costa Rica shape the institutional apparatus needed to undergird the above-mentioned liberalization moves, including: (i) improvements in bank, insurance industry, and capital market supervision; (ii) strengthening of the framework for concessions in the different spheres; (iii) sectoral and regulatory frameworks for infrastructure, utilities and basic services; (iv) modernization of financial management across the public sector; and (v) efficiency improvements in public enterprises.

4.23 A final focus of BSCR support are activities to enhance the urban environment, through programs and projects to help bring low-income populations into the urban development mainstream, encourage sustainable natural resources use and development, and reduce agglomeration diseconomies.[60]

b. Support for development of productive investment[61]

4.24 The BSCR's aim here is to help lower logistical and financial costs in Costa Rica. To that end the Bank Group will support ***transportation sector*** infrastructure development, with priority to local road improvements and road system integration under the Puebla-Panama Plan (PPP). The Bank Group also will help spur **private** investment in highway concessions, ports and airports, providing technical assistance for the entire process and supporting airport security upgrades. The BSCR will continue to support the electric system integration envisaged in the PPP.

4.25 For financial costs to come down in the country (this being key to boosting investment) financial intermediation will have to be more efficient. In order to forge the necessary linkages between leading export sectors and the rest of the economy, support also is needed for efficiency improvements in microenterprises and small and mid-sized businesses, making more **credit** available to these companies and strengthening horizontal integration among SMEs and between SMEs and large corporations. Action on these fronts is more pressing now than ever, given the need to transform production patterns in light of free trade agreements currently on the negotiating table. An important consideration here is that SMEs have traditionally been a major employment outlet for secondary-school graduates.

4.26 Bringing to bear the Bank Group's toolkit, the BSCR will help further ***financial system modernization and liberalization***, exploring alternatives that take equal account of political resolve and the imperative of enhancing the system's efficiency. The strategy will continue to promote business capacity development in sectors with competitive potential—agriculture and tourism being prime targets given their impact on rural development.

4.27 If the country is to achieve parallel factor-productivity improvements sought in the government's strategy, particular attention will have to be paid to ***innovation and technology*** and their incorporation into production processes. The Bank will support the strengthening of innovation and its dissemination, its incorporation into every size and stage of productive processes (with priority to SMEs), and development of the national innovation system. One facet of that new system will be the promotion of women in scientific research.

4.28 Costa Rica's advances in human capital development need to be consolidated and its human resources base needs to be more closely aligned to labor market demands. Greater investment in ***human capital,*** by improving secondary education and increasing its coverage, will make the country's goods and services more competitive and increase the trend growth contribution of labor. (Both the IDB's and World Bank's education programs target low-income minorities.)

4.29 As one way of boosting national productivity the strategy will support the realignment of current production models in order to spur **sustainable rural development** and improve natural resources use and development, especially in border areas, under the PPP.

4.30 The impact of Bank Group activities will be monitored by reference to overall and sector-specific economic activity indicators, microenterprise development indicators, the logistical and financial costs of doing business in the country, labor formation, and productivity gains in various sectors. The increase in nontraditional exports—excluding INTEL—will be used as an output indicator for this strategic area. Thus, the monitoring of this strategy focus will include interim output and outcome indicators which are crucial for timely monitoring, to be able to adjust the strategy to maximize its impact. Details of the indicators are given in the strategy matrix in the executive summary.

C. The lending program

1. The program

4.31 The lending program developed to implement this country strategy is designed to maximize the impact of Bank activities in Costa Rica. Building on the Bank's recent experience in the country and underpinned by continuing dialogue with the authorities, the strategy will support areas that are top priorities for the government and offer prospects of consensuses to pave the way for the programs in question.

4.32 Given Costa Rica's approach to public policy decision-making, objectives are as important in the BSCR as instruments, which will be designed so as to enhance the efficiency and timing of Bank activities in the country. The lending instruments thus will pursue the principles enumerated in paragraph 3.24.

4.33 The 2003-2006 program contains operations with the public sector and other IDB Group windows (Annex I). With a view to maximizing the impact of Bank activities in Costa Rica, the first stage of the ***program to support competitiveness improvements*** is slated for execution in 2003, that operation being key to the proposed strategy's implementation. This hybrid program[62] will support fiscal reforms on both the revenue and expenditure sides to create a stable, growth enabling macroeconomic environment. It also will fund public sector investments to help advance the country's production sectors by way of road improvements, employment-relevant secondary education, technology adoption in production processes, modernization and strengthening of public sector capacity to manage foreign trade and the public finances including the customs service, development of the competitiveness strategy, and improvement of the business climate. Support also is planned for the private productive sector (SMEs) to help these businesses adjust to free trade, through rural development initiatives, realignment of industries and assistance for affected sectors.

4.34 To the extent that the first-stage objectives set for 2004-2005 are attained, the strategy would continue supporting the further strengthening of fiscal discipline with a second stage of the ***program to support competitiveness improvements.*** With funding from two loans—a policy-based loan and an investment loan—that operation would further bolster the public finances in all areas. During this second stage the emphasis will be on reforms needed to enhance spending efficiency by way of performance-based resource allocation and budget reforms. Also slated for support is the strengthening of local governments to modernize their tax revenue collection, administration and service delivery systems. The government has indicated that water and sanitation sector development is one of its investment-program priorities during this second phase, and has requested assistance from the Bank in this regard. Funding will continue in this stage for competitiveness-enhancing investments identified in the first stage, in such areas as streamlining of bureaucracy, modernization of government procurement and contracting, and support for financial reform. Room also will be made for new sectors identified in the course of implementing the competitiveness strategy crafted during the program's previous phase.

4.35 The other facets of the country program will supplement the activities whose common core aim is to improve Costa Rica's competitiveness. In 2003, the ***program for urban poverty alleviation and support for human capital development*** will assist the government in improving the quality of life of poor settlements in cities to help ease them into the urban development mainstream. Orderly management of that process and giving these disadvantaged communities readier access to basic services will help create an environment conducive to economic activity. One special focus of attention will be efforts to help women secure title to property.

4.36 To help improve legislative efficiency and expedite legislative decision-making—both of these being key to the BSCR's approval and implementation—the strategy will support institutional and technical capacity building in the legislature by way of the ***program for modernization of the Legislative Assembly***.

4.37 Sustainable rural development in the **Sixaola River basin** will be supported through a Costa Rica-Panama binational program under the PPP. This venture will deepen integration of the two countries and strengthen border authorities and governments. Funding also will be provided for productive activities, economic diversification initiatives, and projects to lessen these areas' vulnerability to natural hazards. Taken together, these actions will raise the standard of living of local populations.

4.38 Another planned PPP venture for sustainable border-region rural development is the ***program for development of the San Juan River binational basin (Costa Rica-Nicaragua)*** to be implemented in 2004-2005. It will build upon work already under way in the GEF/UNEP project to advance subregional integration.

4.39 Alongside the proposed public sector activities the program makes coordinated use of the Bank Group's **PRI, MIF, and IIC windows** and of the **Social Entrepreneurship Program** to help develop private enterprises of all sizes—microenterprises, small and mid-sized businesses, and large companies—encompassing different sectors such as *roads* and *sanitary sewer systems*. The technical assistance delivered via these products will make for more efficient ***financial intermediation*** and solidify the country's institutional apparatus to attract more private sector involvement, particularly for ***concessions***.

4.40 The program of ***nonlending products*** (see Annex II), which includes technical cooperation, research work and studies, seminars, and policy dialogue support, will advance the intellectual agenda to inform the Bank/country dialogue and foster consensus-building. Among the proposed research topics are the public finances, modernization of the State including the financial sectors, debt management, public enterprises, and sector strategy development, to set the stage for exploring new avenues the BSCR could pursue in its subsequent stages.

4.41 These products also will help develop the lending program and further integration moves under the Puebla-Panama Plan and the free trade accords. One salient contribution of the planned program will be to improve the budgeting and public sector performance evaluation process, which will facilitate the use of eventual new Bank products.

4.42 Reinforcing the new program's development impact will be the outcomes of **loans currently in progress** in the country, which fit with the new strategy's objectives regarding acceleration of competitiveness-driven growth.

4.43 The operations to support *modernization of justice and registry office and cadastre* will help enhance the institutional environment for investment and financial capacity building in municipalities. Two programs currently under way will help *modernize the electric power sector and further its integration with Central*

America. Other ongoing loan operations will support improvements in *competitiveness of small and mid-sized agricultural producers*, human capital development by *strengthening the health sector*, and expanding coverage and improving the quality of *preschool and third-cycle basic education.*

2. Lending scenarios

4.44 The Bank's programming with Costa Rica for the 2003-2006 period will be done in two stages. Once the first stage has been completed, which will last about two years, the program will be evaluated and a decision will be made as to whether to continue with a high scenario or switch to a low scenario. The decision will be based on the evaluation of the scope of the targets set out in the triggers that will determine performance in the implementation of the strategy. The total amount of the program ranges from US$695 million in the high scenario to US$395 million for the low scenario. The centerpiece of the high lending scenario is a two-stage program to support competitiveness increases, with substantial, steady improvements in the public finances to achieve fiscal sustainability, plus investments required to lower the logistical and financial costs of doing business in Costa Rica and strengthen public institutions in order to further trade integration.

4.45 Complementing that core component are four earlier-mentioned programs which together will further integrated border region development as part of the Central American integration process being fostered by the PPP, modernization of the Legislative Assembly, and creation of an urban environment more conducive to economic activity. Such a pro-growth environment is expected to boost private sector investment in infrastructure and in SME-targeted financial intermediation, with support from programs funded through the Bank Group private sector windows.

4.46 If substantial progress is not made in consolidating the country's macroeconomic accounts by strengthening the public finances and there is no concrete progress in the areas of international trade integration and competitiveness strengthening, the low-scenario lending program of US$395 million would be implemented. The programming would thus be adjusted to the reduced fiscal space and considerations of fiscal and public debt sustainability. The low-scenario program will consist of the first stage of the competitiveness improvement program since under this scenario, conditions would not exist to justify the second stage of the program. As in the first stage of the high scenario, projects for urban poverty alleviation and human capital development, modernization of the Legislative Assembly, and Sixaola binational watershed development will be added to the program. The program of direct lending to the private sector through IDB Group windows would be reduced by virtue of the low scenario's less private-investment-friendly environment.

4.47 The triggers that would enable Costa Rica to hold to the high scenario consist of two outcome indicators. These triggers were selected on the basis of their ties to the programming and because they reasonably capture the impact of the government's actions. The indicator to be used in the evaluation of the first strategic area is the reduction of the fiscal deficit at an average annual rate of 1%, taking the 2002 deficit of 5.9% as a baseline, according to IMF data. This is a key factor to achieve macroeconomic stability. The increase in nontraditional exports (excluding INTEL) will be used to evaluate the second strategic area.[63] This indicator reflects a reasonable level of progress towards global trade integration, strengthened competitiveness in the production of goods and services, and the creation of a favorable investment climate. The goal for the 2003-2006 period is an annual average rate of growth of 5%, taking average exports of US$3.49 billion in 2001 and 2002 as a baseline.

D. Coordination with other development cooperation providers

4.48 The Bank works closely with other providers of international development cooperation to Costa Rica, most of whose activities have been affected by the current environment for multilateral finance in the country. Some highlights of the leading providers' activities are summarized in the following paragraphs.

4.49 The **Central American Bank for Economic Integration (CABEI)** continues to maintain an active presence in Costa Rica. Its current undisbursed portfolio stands at US$225 million, spread among eight programs. Two thirds (66%) of that undisbursed portfolio consists of infrastructure and energy loans; the 34% balance is for health, water and sanitation, and education operations. Loans in CABEI's development pipeline will be supporting the *roads sector* and *lines of credit for financial intermediaries*. The bulk of CABEI funding has been channeled to public enterprises that have more expeditious borrowing authorization processes.

4.50 **World Bank.** There are three active projects in the World Bank's Costa Rica portfolio, their undisbursed balances standing at US$41 million for the health, environment, and water and sanitation sectors. Two ongoing Global Environment Facility grant programs totaling US$7 million are supporting diversity and development of Ecomarkets.

4.51 Since preparations for the 2004-2006 Country Assistance Strategy began in the first quarter of 2003, programming details are not yet available. The Costa Rican government has requested World Bank support in the areas of water and sanitation, environment, and education; in the latter sector the World Bank proposes to focus on primary education. Planned technical cooperation operations will help with the management of investment of Central Bank foreign currency reserves and operation of World Bank Institute-sponsored courses, seminars and technical assistance.

4.52 **International Monetary Fund (IMF).** At this writing Costa Rica has no program with the IMF, and there are no plans to tap its funding facilities. In March 2002 the Article IV consultation was concluded and submitted to the Board together with the findings of the Financial Sector Assessment (FSAP). The FSAP results and recommendations were presented to the government in mid-2002. The government has requested technical assistance from the IMF in various areas of public sector financial programming.

4.53 **European Union**. The US$30 million cooperation program for 2001-2006 has three priority focuses: decentralization and municipal strengthening, urban development, and support for the development of high-tech businesses.

4.54 China (Taiwan) and Germany are leading **bilateral cooperation providers**. The former is supporting tourism, education, science and technology, social investment, environmental protection, health sector, and transportation and communications initiatives. Prime targets of Germany's support are agriculture, water and sanitation, and poverty reduction and sustainable development projects and programs.

E. Debt with the Bank and sustainability of the country's external debt with the proposed strategy

4.55 At the end of January 2003 Costa Rica's debt to the Bank came to about US$800 million, which was 1.5% of the Bank's total loan portfolio and about one quarter of the country's external debt stock. In the high lending scenario posited in this country strategy the Bank's country exposure (ratio of outstanding Bank loans to Costa Rica to the overall portfolio) holds at around 1.5% and the ratio of IDB debt service to the country's aggregate debt service also remains at about 25%, equivalent to less than 2% of goods and services exports throughout the BSCR period.

4.56 In contrast to the Bank's relatively low exposure in Costa Rica the country's public debt, poses a risk to the economy and heightens its vulnerability. Of particular concern are the short-term domestic debt, equivalent to 11% of GDP; the high cost of domestic debt service, and the large and widening fiscal deficit. The debt management program instituted by the country is designed to lower the debt service burden; it includes a programmed bond sale in the international market to gradually substitute external debt for domestic debt, particularly short-term obligations. Tighter fiscal discipline is a necessary adjunct to these measures if the public debt is to be sustainable. Unless action is taken in the short and medium term, by the end of the country strategy period the public debt stock could climb to 60% of GDP by 2010, jeopardizing the country's fiscal sustainability.

4.57 The strategy would support moves to improve public debt management and deepen the capital market, the aim being to reduce the relative weight of short-term obligations. The purpose of the support is to help the authorities develop an action plan to improve debt management. Complementing these measures will be support to help instill the fiscal discipline necessary to increase public sector solvency and liquidity.

F. Monitoring and evaluation of the strategy

4.58 Given the state of institutional development in Costa Rica, the National Evaluation System (SINE) can be adopted as the core tool for monitoring and evaluating the

Bank's country strategy. That system, which was set up to evaluate and monitor the National Human Development Plan to which the Bank aligned its previous strategy, is a public sector management tool that provides feedback for decision-making with the aim of enhancing the workings of government.

4.59 The country performance indicators built into the strategy were developed by reference to National Development Plan targets. Achievement of these indicators will hinge not just on the Bank's participation but also on the resolve and commitment evinced by the country and on the international climate.

4.60 However, for timely monitoring of the strategy to be able to quickly identify any required adjustments, a set of output and input indicators more closely related to the Bank's direct interventions needs to be used. A set of interim indicators has been built into the strategy to that end; which are set out in detail in the strategy matrix.

4.61 Monitoring and evaluation is an integral piece of the proposed country strategy, which envisages linkages between loan execution and the new performance budgeting system. Consequently, during the life of the strategy the SINE will be strengthened to create the necessary framework for improved resource allocation.

4.62 The strategy likewise provides for continual monitoring of the public policy dialogue slated for support via the Bank's nonlending products. This will enable dynamic and timely identification of the support the country needs to build consensuses.

Box 4.1 Costa Rica's performance assessment system

Costa Rica's National Evaluation System (SINE) attached to the Planning Ministry assesses the attainment of strategic actions to which the various government agencies have committed in the National Development Plan.

Each agency draws up an annual work plan (action pledge) in which it outlines priority actions, with a matrix showing the targets set, how their attainment will be measured, and their specific weight in the overall evaluation. Subsequently the agency signs a public document, countersigned by the President of Costa Rica, setting out its commitments. At the end of the year the SINE compares achievements against commitments and releases the evaluation findings to the public.

SINE is an excellent tool for guiding Costa Rica's public administration toward results-based management. It is important that institution-strengthening of the SINE continue, connecting it to the budget approval process, instilling a contract culture in government institutions, bringing more agencies into the system, and fostering civil society involvement in the evaluation.

4.63 Monitoring of the programs envisaged in the strategy will include the following activities:

- Monitoring the execution of active loans and of new programs to see that they align with government priorities and assess their evaluability and impact.
- Periodic meetings with the SINE to review the different sectoral baselines and changes therein.
- Quarterly monitoring and annual meetings to review portfolio performance with the authorities.

- Annual reviews of the BSCR as part of the programming exercise, to review indicators, update the strategy and adjust it as necessary.
- Coordination meetings and joint missions with other multilateral organizations.

4.64 The BSCR matrix in the executive summary of this paper presents two sets of indicators. The first set, listed in the second column from the right, are indicators proposed by the government. Though primary responsibility for achieving the respective targets lies with the government, the Bank's program set out in this strategy paper will assist the government in attaining them. Heading this first group of indicators are a reduction in the poverty rate from 20.5% in 2002 to 16% in 2005, an increase in GDP growth from 2.8% in 2002 to 4.5% in 2006, a reduction in the fiscal deficit, and an increase in nontraditional exports (without INTEL). These indicators serve as guidelines for the BCSR.

4.65 The second set of indicators in the BSCR matrix (right-hand column) reflect outcomes sought with the Bank's program. Though the commitment is primarily on the government's part, here the Bank and the country will share responsibility for attaining the targets.

4.66 Some of the targets set out in the BSCR will be a challenge for the government, and can only be achieved through a concerted effort by the government backed by strong international community support. Outside factors that could impede their attainment include natural disasters and political, economic or financial unforeseeables. Consequently, an evaluation of the Bank's role in achieving the indicators will have to take into account considerations of responsibility-sharing and counterfactuals that have come in for lengthy discussion in the Bank's Board of Executive Directors.

G. Risks of the proposed strategy

4.67 The risks the BSCR may face are associated with implementation of the country's own National Development Plan. In light of Costa Rica's experience with reforms in recent years and its relations with the Bank in previous programming exercises, the risk analysis centered on political factors associated with the reform processes. Unless the requisite consensus is achieved on implementing the proposed fiscal reform, the country's fiscal sustainability could be jeopardized. This would have implications for macroeconomic stability, which is a sine qua non for robust growth.

4.68 The strategy backs the government's commitment on this front by supporting a process of dialogue, which has already been launched with a fiscal reform workshop held with the Legislative Assembly. In view of the success of this workshop, the government has already requested the Bank's support in establishing a communication strategy to promote the State reform agenda. Major strides have been made toward the reforms, starting under the previous strategy with support for the committee of former finance ministers whose recommendations were written into the National Development Plan and were the basis for the draft legislation. Attesting to the strength of the government's resolve was the adoption of temporary measures, now being implemented, and the Fiscal Adjustment bill introduced in the legislature. These actions afford assurances of high quality at entry of the support envisaged for these reforms in the strategy. An adjunct to the public sector strengthening activities is support for concession arrangements to help attract private capital for infrastructure finance.

4.69 The strategy also supports debt management improvements and institution-strengthening needed to improve government financial management, which ultimately will bolster the public accounts.

4.70 Compounding the risk referred to above is the vulnerability of Costa Rica's economy to shifting global conditions. A decline in the terms of trade, sluggish global growth, and a falloff in inflows of external finance or changes in their terms and conditions would dampen the country's growth prospects and weaken its external position. The BSCR will be supporting competitiveness improvements in the goods and services producing sectors to help the country position itself more solidly in the global marketplace.

4.71 The private sector's response to the new economic climate in the country will be key to achieving the objectives set out. The BSCR will directly support private sector activities in the infrastructure area and those targeted to SMEs, as well as strategies to boost exports and create industry clusters.

4.72 The slow pace of multilateral-loan negotiation and approval processes could seriously impede the strategy's efficiency and effectiveness. Future Bank programs will be designed so as to shorten the time needed for approval formalities, taking advantage of programming economies of scale that are yielded when programs are grouped by activity focus.

4.73 Serious efforts are under way to build institutional capacity for the implementation of projects receiving multilateral funding and to simplify designs and procedures. However, program implementing capacity could be a serious constraint for the BSCR's efficiency, deferring its impact and lowering programs' economic returns. The strategy provides for instruments to expedite these processes and shorten approval times so loan execution can begin quickly, thereby enhancing the respective programs' implementation prospects.

4.74 Since the Bank's objectives are intertwined, these risks cut across the strategy. Hence, rather than deal with them separately under each objective, they are reviewed as a whole in this section.

V. AGENDA FOR THE COUNTRY DIALOGUE

5.1 The centerpiece of the agenda for dialogue with the Costa Rican government will continue to be the monitoring of the program to improve the public finances and modernize the public sector and the success in building consensuses around the public policy agenda. Another monitoring focus will be the proposed financial system reforms, to assess the need for support to open that sector further to private enterprise.

5.2 Other activities to be tracked are the competitiveness program and developments in trade agreements and treaties, reviewing their impact and implementation of the respective action plans, and investment needs ensuing from the competitiveness strategy, the impact of the new global integration environment on Costa Rica, and the Puebla-Panama Plan (PPP).

5.3 The Bank proposes to continue the dialogue on the financial costs of having a centralized State model and the ensuing implications for economic growth. Decentralization moves should unfold within the framework of the existing social compact that gives priority to societal welfare.

5.4 Work to strengthen the SINE and improve budget performance will be very closely monitored with a view to creating a framework from which to assess the feasibility of developing a performance-based program as the Bank's product menu evolves.

5.5 Monitoring of the nonlending product programming will be an important facet of the dialogue with the authorities, to review those products' alignment with government priorities and assure their impact and relevance. Close coordination will be maintained with activities and studies in progress in the country and with the programs of other development cooperation providers. All these activities will enrich the Bank's intellectual contribution to the country and heighten its development impact.

5.6 Among the items on the agenda for dialogue with the authorities will be the status of the portfolio and implementation of the action plans, seeking to build into the country program other activities that can continue to improve and expedite program execution.

SUMMARY OF THE BANK'S OPERATION PROGRAM

2003 LENDING PROGRAM AND PRELIMINARY 2004-2006 PIPELINE
[US$ MILLION]

Program	Scenarios		Objective
	Low	High	
2003 program			
Program to support competitiveness improvements (first stage) • Support for competitiveness reforms (PBL) • Investment Facility for Growth and Competitiveness I	**300.0** 100.0 200.0	**300.0** 100.0 200.0	• Support the authorities in accelerating economic growth as the only way to secure sustainable improvements in living standards and sustainable reductions in poverty. To this end, the Bank will support fiscal reforms to create a stable, investment-friendly macroeconomic environment that also will enable government actions to improve competitiveness and thereby achieve sustainable growth. • Provide support for investments to further production growth in the country, through improvements in roads, employment-relevant secondary education, knowledge generation and adoption of technology in productive processes, export development, SME development, adjustments in key institutions, including local governments, to support free trade agreements, cut red tape and streamline regulations.
Modernization of the Legislative Assembly	**20.0**	**20.0**	Build institutional and technical capacity in the legislature to enhance law-making efficiency and transparency; better equip the Assembly to perform its role as civil society's representative; set up a permanent legislative cross-training system, and improve technology support at the institutional level and for dealings with the public. Taken together, these measures will expedite legislative decision-making.
Urban poverty alleviation and human capital development	**50.0**	**50.0**	Improve the quality of life of residents of poor urban settlements. Specific objectives: (i) help instill participatory practices for development, selection and prioritizing of actions intended to benefit these poor communities; (ii) promote gradual improvements in the habitability of these settlements; and (iii) promote changes that will help ease these communities into the urban mainstream.
Regional program for the Sixaola River binational basin (support for Costa Rica–Panama integration)	**10.0**	**10.0**	Support sustainable natural resources management (GEF/Bank project), development of productive activities and economic diversification, initiatives to reduce the country's vulnerability to natural hazards, deepening of the two countries' integration processes (PPP), and strengthening of border authorities and governments.
Subtotal 2003	***380.0***	***380.0***	

Program	Scenarios		Objective
	Low	High	
2004-2006 pipeline			
Program to support competitiveness improvements (second stage) • Support for strengthening the public finances (PBL) • Investment Facility for Growth and Competitiveness II		**300.0** 100.0 200.0	• Support government efforts to make public spending more efficient, furthering budget reforms and performance-based resource allocation. • Help lower the cost of doing business in Costa Rica and spur SME development. At the regional level, create an enabling environment for sustainable development, supporting actions and investments that yield economic, social and environmental benefits, with due regard to their potential and limitations. Revamp current production and natural resources development models to assure their sustainability and promote their diversification, orient public and private investment in infrastructure and public services; raise income and improve quality of life.
Regional program for development of the San Juan River binational basin (support for Costa Rica-Nicaragua integration)	**15.0**	**15.0**	Sustainable border region development, tapping the natural wealth of these areas and addressing their limitations. Building on work in progress under the GEF/UNEP project, support the development of productive activities, basic infrastructure endowment, and the two countries' integration under the Mesoamerican Development Initiative (PPP).
Subtotal 2004-2006	***15.0***	***315.0***	
TOTAL 2003-2006	***395.0***	***695.0***	

TECHNICAL COOPERATION PROGRAM
[US$000]

Project number	Project name	Amount
2003-2006		
I. Consolidation of macroeconomic stability		
TC-0301022	Modernization of spending, taxation, and the Investment Fund for Growth and Competitiveness	325.0
TC-n/n	Social spending study	300.0
TC-0103024	Municipal program for financial sustainability and competitiveness	300.0
II. Acceleration of production growth to seize global integration opportunities		
TC-n/n	Strengthening the National Evaluation System (SINE)	700.0
TC-0202044	Heredia sewer system project	150.0
TC-0210056	Sustainable development of Huetar-Vertiente Atlántica-Limón region	600.0
TC-0211010	Mainstreaming low-income communities and productive development	400.0
TC-n/n	Science and technology and productive development	150.0
TC-0201091	National environmental management strategy and reengineering of Environment and Energy Ministry	470.0
TC-0212035	Integrated water resources management strategy and Water Resources Act	265.0
TC- n/n	Natural resources management in the Sixaola River binational basin (GEF/Bank project)	2,000.0
TC-0203003	Diagnostic assessment of water and sewer services in Alajuela	40.0
TC-n/n	Border region development strategy for San Juan River binational watershed (Costa Rica-Nicaragua)	350.0
TC-0301067	Secondary education	149.8
TC-0305006	Women in science and technology	70.0
TC-n/n	Management training program	1,000.0
TOTAL		**7,739.8**

SOCIAL ENTREPRENEURSHIP PROGRAM (SEP)
[US$000]

<table>
<tr><th>Project number</th><th>Project name</th><th>Amount</th><th>Strategy objective</th></tr>
<tr><td>SP0204003</td><td rowspan="2">Expansion of microcredit for communities in southern Costa Rica</td><td>500</td><td rowspan="4">Accelerate production growth to seize global integration opportunities</td></tr>
<tr><td>TC0204003</td><td>150</td></tr>
<tr><td>SP0204014</td><td rowspan="2">Production and marketing of organic export crops in southern Costa Rica</td><td>350</td></tr>
<tr><td>TC0204014</td><td>250</td></tr>
<tr><td colspan="2">TOTAL</td><td>1,250</td><td></td></tr>
</table>

THE IDB GROUP PRIVATE SECTOR WINDOW

MULTILATERAL INVESTMENT FUND (MIF) PROGRAM
[US$000]

Project number	Project name	Amount
TC0211007	Institutional support for National Concessions Council	500
TC0201104	San José–Cartago freeway concession	300
TC0205041	Strengthening of airport security	500
TC0301003	Cleaner production in business sector	750
TOTAL		**2,050**

PRIVATE SECTOR DEPARTMENT (PRI) PROGRAM
[US$ million]

Project number	Project name	Amount
CR0143	San José–Caldera highway	64.2
TOTAL		**64.2**

INTER-AMERICAN INVESTMENT CORPORATION (IIC) PROGRAM
[US$ million]

Project name	Amount
Expansion of free zone technology park	16.5
Leasing line of credit	5.0
TOTAL	**21.5**

PROGRAM OF RESEARCH AND ANALYTICAL PAPERS[64]

Research papers, notes, seminars	Description
Consolidation of macroeconomic stability	
Costa Rica. Economic Situation and Prospects	Analysis of the country's macroeconomic situation.
Tax policy for human development	Menu of tax policies that can boost tax revenues and thereby increase public funds, pay for human capital formation, and reduce reliance on grants.
Regional review	Analysis of the Costa Rican economy's regional backdrop.
Acceleration of production growth to seize global integration opportunities	
Financial issues	
Financial sector monitoring system	Development of an analytical database to identify and compare strengths and weaknesses of financial systems in the region against international standards (Basle principles).
Central American rural finance strategy	Identify plans and measures that could be implemented with IDB support to improve financial and nonfinancial services delivery in rural areas.
Integration issues	
Free trade agreement between Central America and the U.S.A. (FTA-CA)	Regional analysis of key issues for Costa Rica in FTA-CA negotiations.
Assessment of potential FTA-CA impacts	Analysis of FTA-CA challenges for Costa Rica in selected economic sectors.
Social issues	
Private sector involvement in post-secondary education	Ascertain effective demand and resource requirements for creating public-private sector partnerships to devise and run quality post-secondary programs geared to labor market needs.
Impact and performance measurement in social project management	Instilling a results-based approach in social program design and management poses technical and methodology challenges, which this study will address.
Employment and training system	Establish general guidelines for assisting countries in the region to develop training and employment systems.
Production-related and environmental issues	
Analysis of clean development prospects in Central America	Assess potential opportunities for five Central American countries under the Clean Development Mechanism. Identify current institutional barriers to maximizing benefits and how to remove these impediments.
Action plans to tackle key urban environment issues in Central America	Diagnostic assessment of urban environment issues in Central America to produce an action plan for the Bank to identify effective measures and priority areas for investment for the urban environment.
Water resources / Potable water and sanitation	Examine the nature and structure of water and sanitation demand. Determine the distributional effects of the price of water.

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[1] Includes PRI, MIF, and IIC activities.
[2] Considers the high scenario.
[3] This target, like the other macroeconomic ones, are indicative. In addition, the assumption is that the other factors remain constant.
[4] D. Kaufmann, A. Kraay and P. Zoido-Lobaton, "Governance Matters II: Updated Indicators for 2000/01." World Bank, Washington, D.C., 2002. These findings tally with other measurements, for instance those of Transparency International and the 2001 Global Competitiveness Report.
[5] Latinobarómetro (2002).
[6] Information in this section is based on the World Bank report "Costa Rica: Social Spending and the Poor," 31 October 2002, and on the eighth report on State of the Nation in Sustainable Human Development, 2002.
[7] The results are less satisfactory if poverty is analyzed using the Unmet Basic Needs Index, which measures the percentage of households without access to basic social services, since the percentage of households with at least one unmet basic need dropped from 47% in 1989 to 40% in 2000, suggesting that cash earnings have increased more quickly than basic social services. Source: Juan Diego Trejos Solórzano, Evolución de los hogares con carencias críticas en Costa Rica, Eighth Report on the State of the Nation in Sustainable Human Development, 2002.
[8] Source: World Development Indicators, 2002.
[9] The Gini coefficient is an aggregate numerical measure of income inequality, ranging from 0 (perfect equality) to 1 (perfect inequality).
[10]. María Elena Ruiz, "Challenges and Opportunities for Gender Equality in Latin America and the Caribbean." World Bank, 2003.
[11] Around 26% of Nicaraguan immigrants are poor; 8.9% are living in extreme poverty. Source: International Organization on Migration. Binational Study: The State of Migration between Costa Rica and Nicaragua, 2001.
[12] Juan Diego Trejos Solórzano, "Inmigración internacional y pobreza en Costa Rica," 2003.
[13] To maintain data consistency, statistics used in this paper are taken from the IMF Staff Report for the Article IV Consultation, 7 February 2003.
[14] Total factor productivity in the period 1991-1999 was 1.1% (Source: IDB/Region 2, November 2002, "Las economías de los países centroamericanos y la República Dominicana: Evolución y desafíos de largo plazo".)
[15] Excluding net factor income from abroad, reflecting only the added value that remains in the country.
[16] Excluding raw materials imports of companies covered by special export regimes, the net international reserve stock is equivalent to four months of imports.
[17] Refers to the multilateral effective real exchange rate.
[18] IMF, Staff Report for the Article IV Consultation, 2003.
[19] See chapter II, "Key Development Challenges."
[20] IMF, Staff Report for the Article IV Consultation. February 2003.
[21] The government's most recent bond sale (January 2003) was priced at 410 basis points over U.S. Treasury bonds.
[22] The Standard & Poor´s downgrade reflects the risk of heightened economic vulnerability in the event of deviations in the public finances and increased financial-system exchange risk.
[23] In particular, financial sector reforms and increased private sector involvement in infrastructure sectors. It is understood that there are difficulties in moving forward on this reform package in Costa Rica, but the private sector can be given a greater role via concession contracts.
[24] See IMF Staff Report, February 2003, which assumes United States GDP growth of 3.6 on average for 2002-2006 and a LIBOR rate that increases gradually to 5.5% in 2006.
[25] In 2000-2002 Costa Rica sold US$250 million worth of securities annually on the capital markets.
[26] Described in chapter II, "Key Development Challenges."

27 Costa Rica's growth pattern in the last two decades was driven by capital accumulation and changes in total factor productivity (labor and capital). A breakdown of 1980-2000 growth using the traditional accounting framework shows the slowdown starting in 1995 to be associated with a decline in the total factor productivity that had fueled growth since 1986 and the stagnation of the share represented by the increase in capital since the mid-1990s. An important consideration here is that labor's contribution remained virtually unchanged over the entire period under review. (IMF, Costa Rica Staff Report Article IV Consultation, and José Antonio Cordero, "El crecimiento económico y la inversión: el caso de Costa Rica.")

28 Judging from international experience, a country is unlikely to post sustainable growth rates in excess of 5% unless it invests one quarter of GDP in fixed capital. Costa Rica is investing less than one fifth of GDP.

29 Less than the equivalent of 13% of GDP. Costa Rica has a tax burden similar to that of El Salvador, which has half Costa Rica's per capita income.

30 In 2002, the Supreme Court Fourth Circuit handed down its opinion regarding the non-obligation on the government's part to fulfill these obligations if the public treasury is not in a position to do so. However, this ruling does not solve the spending-propensity problem created by the current legislation.

31 Jorge Cornick, "Políticas tributarias para el desarrollo humano en Centroamérica y la República Dominicana." IDB, January 2003.

32 Tariffs averaged 6.1% in 2000, with 8.3% dispersion. The sum of exports and imports as a percentage of GDP ranged between 55% and 45% in the period 1994-2002.

33 Free Trade Agreement between Central America and the United States (FTA-CA), Free Trade Agreement of the Americas (FTAA), and Free Trade Agreement with the European Union (FTA-EU).

34 D. Kaufmann, A. Kraay and P. Zoido Lobaton, 2001.

35 Countries like Costa Rica whose initial institutional capabilities are more advanced require additional institutional-solidification efforts to revive growth. Rodrik, 2002.

36 The firm Unimer Reseach International surveyed 1,400 Costa Ricans in August 2002, asking about the quality of public services. Electricity was the favorite, with 90% saying they were very or quite satisfied. Education and telephone were other services that received high marks (81% and 76%, respectively).

37 Among the initiatives launched to expand coverage and improve service quality are draft legislation to privatize Internet services and to institute a benchmarking system for public utility pricing, based on the situation in Costa Rica's principal competitors.

38 Deposits in government-owned banks are fully insured (those institutions enjoying full government backing); private commercial banks are required to put 17% of their deposits into public banks. Toward the end of 2002 the government tabled bills in Congress to amend the Central Bank Act and the Bank Act, to revise both of those requirements. The bills are still before Congress.

39 Intermediation spreads in Costa Rica (between 8 and 10 percentage points) are substantially higher than in competitor economies, notably El Salvador (3-4 points). High lending rates in colones encourage dollar borrowing, which is cheaper, leaving the economy more vulnerable to exchange-rate fluctuations and narrowing the margin for flexibility in economic policy.

40 (1) the public pillar, a benefit-based plan run by the Costa Rican Social Security Administration; (2) the private pillar, a mandatory contribution system featuring personal pension accounts managed by the financial system; and (3) a voluntary personal pension system.

41 In late 2002 the new administration brought in measures to improve banking supervision and capital market efficiency. It also introduced reform bills in the legislature to create a deposit insurance system for commercial banks, reduce some of the preferential treatment enjoyed by government-owned banks, including a reduction from 17% to 10% in the share of total commercial bank deposits that must be held in public banks, and give the publicly owned banks greater administrative autonomy.

42 Microenterprises and small and medium-sized businesses defined as having fewer than 100 employees.

43 Between 1994 and 1998 informal SMEs (fewer than 20 employees) created 27% of all new jobs, compared to the 21% share of the total generated by formal SMEs. J. D. Trejos (1999), "La microempresa de los noventa en Costa Rica." Cuadernos de Trabajo No. 2, PRONAMYPE. PROMICRO-ILO Central American Project. San José, 1999.

44 Young people who are poor are half as likely to make it to high school as their counterparts from better-off families; only 15% of 20-year-olds in the lowest income quartile have completed 12 years of schooling,

compared to 60% in the wealthiest quartile. Over one third (38.2%) of university students come from the highest income quintile; only 1.6% are from the bottom quintile. World Bank (2002).

[45] According to a recent study on social spending in Latin America, the long-run efficiency of Costa Rica's education sector is low, its indicators being worse than what they should be given the country's GDP, and expenditures are over budget. Tarsicio Castañeda (2002) and Ana Corbacho and Hamid Davoodi (2002).

[46] In Upala de Alajuela coverage is 53.3%; in Montes de Oro it is 90.8%. Ministry of Health (2002). Costa Rica: Health Sector Analysis.

[47] Costa Rica, Social Spending and the Poor, Vol. II. World Bank, p. 53 vi. 31 October 2002.

[48] Most recent data (31 October 2000): 157,346 dwellings; 100,801 in rural areas. Source: 2002-2006 National Development Plan.

[49] Trailing Brazil, Mexico and Panama, according to Harvard University's Network Readiness Index.

[50] Compare this with the 2%-3% of GDP which the advanced nations invest annnually in science and technology.

[51] Activities supported by two active sector loans that were in progress in 2000 (public sector adjustment program—loan 739/OC-CR, and investment sector program—loan 742/OC-CR).

[52] At 31 December 2002.

[53] Two singularly successful agriculture projects executed by the Bank over this period, conceived with an integrated approach, were the Coto Sur agroindustrial development program and the second stage of the Tempisque Valley irrigation program.

[54] Extensive discussion is a fixture of the consensus-seeking tradition. On average it takes between 8. and 11 months for a Bank loan to become effective.

[55] Proba, LP, Central American Banking Growth Fund, Aureos Central American Fund, and PLG.

[56] Despite some improvements the procurement system still has weak points owing to the lack of harmonization in procurement and contracting organization and practices that leave a margin for discretion. Some compounding factors are a lack of specialized personnel and a procurement planning system and multiple controls that add no value and lose their content.

[57] Central Bank of Costa Rica deficit.

[58] See chapter II, section 2, page 9.

[59] This section addresses challenges relating to the institutional environment and the environment needed for infrastructure development.

[60] Refers to costs associated with pollution, lack of security, congestion, marginalization, and loss of social cohesion, among others.

[61] Covers challenges involving infrastructure, financial services, human capital, and sustainable rural development.

[62] Called a "hybrid program" because it includes a PBL component and an investment component, in a biunial relationship that taps the synergy created by the two products.

[63] The inclusion of this firm would make the strategy too dependent on the corporate decisions of a single firm.

[64] The program of nonfinancial programs is tentative and subject to discussion with the government. Financial support from a number of trust funds is expected for several of them.